

Purchase Money Inventory Financing: The Case For Limited Cross-Collateralization

MARK B. WESSMAN*

Article 9 of the Uniform Commercial Code specifically authorizes the use of after-acquired property clauses¹ and future advance clauses² in security agreements. By including an appropriately-drafted clause of each type in a security agreement, a secured creditor can achieve full cross-collateralization.³ Assuming the secured creditor appropriately perfects⁴ his security interest (and maintains continuous perfection),⁵ full cross-collateralization enables the secured creditor to achieve priority over a broad range of rival claimants to the collateral.⁶

The Code also permits the creation and perfection of a special type of security interest, the purchase money security interest,⁷ which is accorded special status.⁸ The most important feature of purchase money status is that a purchase money security interest is accorded special priority,⁹ even over previously-perfected nonpurchase money security interests which, but for the purchase money status of the later security interest, would be superior to it.¹⁰

Given the respective advantages of cross-collateralization and purchase money status, it was perhaps inevitable that secured creditors would try to combine the benefits of both in a single financing arrangement. Based on the results of reported litigation to date, however, such attempts must be classified as at best risky, and at worst, disastrous.¹¹

* Associate Professor, Tulane Law School. The author wishes to express his thanks to Lissa Broome, William D. Hawkland, Homer Kripke, Robert Lloyd, and Shael Herman for reading prior drafts of this Article.

1. Uniform Commercial Code § 9-204(1). All citations to the Uniform Commercial Code ("U.C.C." or "Code") will be to the 1987 Official Text. U.C.C. § 9-204(1) provides: "Except as provided in subsection (2), a security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral."

2. U.C.C. § 9-204(3), which provides: "Obligations covered by a security agreement may include future advances or other value whether or not the advances or value are given pursuant to commitment (subsection (1) of Section 9-105)."

3. The term "full cross-collateralization" will be used in this Article to refer to an arrangement between a debtor and a secured creditor (whether under a single agreement or a series of cross-referenced agreements) under which each and every advance by the secured creditor to the debtor, regardless of purpose or ultimate use, is secured by all the collateral the secured creditor claims, regardless of the time the collateral is acquired or the advances are made.

4. See *infra* notes 50-60 and accompanying text.

5. See *infra* notes 61-66 and accompanying text.

6. See *infra* notes 61-90 and accompanying text.

7. See *infra* note 204 and accompanying text for the definition of "purchase money security interest" under U.C.C. § 9-107.

8. See Lloyd, *Refinancing Purchase Money Security Interests*, 53 TENN. L. REV. 1, 3 (1985). Professor Lloyd identifies three principal "purchase money privileges": 1) immunity from avoidance in bankruptcy under § 522(f) of the Bankruptcy Code; 2) exemption from the filing requirement for perfection if the collateral is consumer goods; and 3) priority over previously-filed security interests in the same property. *Id.* This article will devote the most attention to the third privilege, the purchase money priority.

9. See U.C.C. § 9-312(3) and (4).

10. See *infra* notes 91-105 and accompanying text.

11. See *infra* notes 184-202 and accompanying text.

The focus of this Article is on purchase money financing of the type of goods which the Code classifies as "inventory."¹² My thesis is that there is a limited form of cross-collateralization which ought to be available to the purchase money inventory financier under the Code. That limited form of cross-collateralization is consistent with the language of the Code, amenable to business justification, and consistent with any of several plausible policy justifications for purchase money priority. In order to establish my thesis, however, it will be necessary to consider and refute a series of stock arguments allegedly establishing a fundamental incompatibility between cross-collateralization and purchase money status. Those arguments have been developed, not primarily in the context of litigation over inventory financing, but in litigation over such diverse matters as equipment financing, the financing of consumer goods, and consumer and business bankruptcies. Aside from the fact that they suffer from the usual evils of transplantation, the stock arguments fail to attend to significant differences between full and limited cross-collateralization.

This Article will proceed in the following order. Part I will begin with a brief overview of the Article 9 scheme for the creation and perfection of security interests in personal property.¹³ The second half of Part I will include a brief discussion of the principal justifications which have been offered for the special status accorded to purchase money security interests.¹⁴

Part II will introduce three hypothetical paradigm cases of purchase money inventory financing arrangements.¹⁵ While all three are abstracted and simplified in order to facilitate analysis of the critical issues and policies, each has analogues in both reported cases and contemporary business practice.

In Part III, the three hypothetical paradigms will be used as vehicles to explore the merits and limits of the arguments for and against permitting purchase money financiers to cross-collateralize.¹⁶ The arguments examined will include those appearing in reported cases and in the critical literature. The conclusion drawn from the analysis will be that the objections which have been raised to limited cross-collateralization are invalid and that limited cross-collateralization is consistent with the language of the Code and the policies behind the purchase money priority.

12. See *infra* note 94 for the definition of "inventory" under U.C.C. § 9-109(4). This Article concentrates on inventory because the problems it presents are special, in part due to its transient nature and in part due to the presence in the provision for purchase money priority in inventory (U.C.C. § 9-312(3)) of unique notice requirements and special restrictions on the secured party's claim to proceeds. Thus, while it is probable that many of the arguments made subsequently concerning purchase money inventory financing translate to other kinds of purchase money financing, such carryover is not automatic.

13. See *infra* notes 17-106 and accompanying text. Section I.A. is intended to set a context for readers without extensive experience with Article 9. Teachers of commercial law and others with substantial expertise in personal property financing should proceed to Section I.B.

14. See *infra* notes 107-72 and accompanying text.

15. See *infra* notes 173-83 and accompanying text.

16. See *infra* notes 184-357 and accompanying text.

I. THE CONTEXT AND BASIS FOR PURCHASE MONEY PRIORITY

A. *The General Article 9 Scheme*

Article 9 was intended by its drafters to set out "a comprehensive scheme for the regulation of security interests in personal property and fixtures."¹⁷ The goal of comprehensiveness was accompanied by a concern for the simplification of personal property security.¹⁸ Accordingly, the drafters substituted the generic term "security interest"¹⁹ for the bewildering variety of personal property security devices²⁰ available (and necessary) under pre-Code law.²¹

The Code defines a "security interest" as "an interest in personal property or fixtures which secures payment or performance of an obligation."²² The obligor is termed the "debtor";²³ the obligee is called a "secured party";²⁴ and the property subject to the security interest is the "collateral."²⁵ Collateral is further subdivided into several types,²⁶ including goods,²⁷ documents,²⁸ instru-

17. Official Comment, U.C.C. § 9-101. There are, of course, exceptions to the stated aim of comprehensiveness. The next paragraph of the Official Comment to § 9-101 specifically disclaims any intent to supersede regulatory legislation governing consumer loans and consumer installment sales. Section 9-104 contains a further list of excluded transactions. *See also* Official Comment to U.C.C. § 9-102 (main purpose of § 9-102 is "to bring all consensual security interests in personal property and fixtures under this Article, except for certain types of transactions excluded by Section 9-104."). *See also* 1 G. GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* § 10.1 at 295-97 (1965).

18. *See* Official Comment, U.C.C. § 9-101 (noting the "growing complexity of financing transactions" resulting from the proliferation of pre-Code security devices, the consequent legislative habit of "piling new statutory provisions on top of our inadequate and already sufficiently complicated nineteenth-century structure of security law," and expressing an aim to "provide a simple and unified structure within which the immense variety of present-day secured financing transactions can go forward with less cost and with greater certainty." *Id.*). *See also* 1 G. GILMORE, *supra* note 17, § 10.1 at 295-97.

19. Official Comment, U.C.C. § 9-101. *See also* 1 G. GILMORE, *supra* note 17, § 10.1 at 295-97 and § 11.1 at 333-37; Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien"*, 72 HARV. L. REV. 838, 845-47 (1959).

20. A list of pre-Code security devices appears in U.C.C. § 9-102(2), and that section explicitly authorizes the continued use of the old forms. *See also* Official Comment, U.C.C. § 9-101. The rules of Article 9, however, apply to "any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures . . ." U.C.C. § 9-102(1). *But see* Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 912 (1986) (questioning the assumption that security is a "meaningful generic concept" and suggesting that no single explanation can rationalize diverse financing patterns).

21. The classic history and exposition of pre-Code personal property security devices is 1 G. GILMORE, *supra* note 17, §§ 1.1-8.8 at 5-286. More abbreviated historical accounts include Lloyd, *supra* note 8, at 10-37.

22. U.C.C. § 1-201(37). The material quoted in the text is only the opening sentence of a rather lengthy section. The remaining material, however, is a set of qualifications (not material to this article) intended to resolve special definitional problems, including problems concerning a reservation of title by a seller of goods, the buyer's "special property interest" in goods upon their identification to a contract of sale, consignments of goods, and the distinction between leases which are or are not intended as security.

23. "Debtor" is defined in U.C.C. § 9-105(1)(d). For the sake of simplicity, it will be assumed in this Article that the term "debtor" normally denotes a person obligated to pay a sum of money.

24. "Secured party" is defined in U.C.C. § 9-105(1)(m). For purposes of simplicity, this Article will focus on secured parties who are either sellers of goods or lenders of money and ignore the special complications which attend purchases of accounts or chattel paper as well as any special complexities which occur when a secured party is a trustee.

25. "Collateral" is defined in U.C.C. § 9-105(1)(c).

26. *See* U.C.C. § 9-102(1)(a). For the history of, and commentary on, the Code's collateral classification scheme, see 1 G. GILMORE, *supra* note 17, at 288 and §§ 12.1-12.6 at 367-87, §§ 9.1-9.2, 12.1-12.6.

27. The term "goods" is defined in U.C.C. § 9-105(1)(h) and further subdivided in U.C.C. § 9-109.

28. "Document" is defined in U.C.C. § 9-105(1)(f) by cross-reference to § 7-201(2) and the general definition of "document of title" in § 1-201(15).

ments,²⁹ general intangibles,³⁰ chattel paper,³¹ and accounts.³² The category of "goods" is further broken down into "consumer goods,"³³ "equipment,"³⁴ "farm products,"³⁵ and "inventory."³⁶ When goods are "so related to particular real estate that an interest in them arises under real estate law," they are classified as "fixtures."³⁷

It is comparatively easy to create a security interest which will be effective between the immediate parties to a single financing transaction, the debtor and the secured party. A security interest becomes enforceable between the debtor and secured party (and is said to "attach") when the secured party has given "value,"³⁸ the debtor has rights in the collateral,³⁹ and either of two further conditions is satisfied.⁴⁰ Either the secured party must be in possession of the collateral "pursuant to agreement," or the parties must have a written security agreement, signed by the debtor, which contains a description of the collateral.⁴¹

Attachment is not an entirely insignificant step, for it does give the secured party the right, upon default by the debtor, to resort to the rather considerable remedial provisions of Article 9.⁴² Those remedial provisions include the power to repossess and dispose of the collateral and apply the proceeds to the secured debt.⁴³ The right to proceed directly against the assets constituting collateral is theoretically the main reason to take a security interest at all.⁴⁴

Nevertheless, a security interest which has merely attached is scant protection against the risk of the debtor's nonpayment. If the secured party does nothing further, his interest in the collateral will be subordinate to any judgment creditor of the debtor who obtains a lien on the collateral by attachment, levy, or similar procedure,⁴⁵ to the debtor's trustee in bankruptcy in the event the debtor files a petition,⁴⁶ to a wide range of buyers of the collateral,⁴⁷ to any

29. "Instrument" is defined in U.C.C. § 9-105(1)(i).

30. "General intangibles" is defined in U.C.C. § 9-106.

31. "Chattel paper" is defined in U.C.C. § 9-105(1)(b).

32. "Account" is defined in U.C.C. § 9-106.

33. U.C.C. § 9-109(1).

34. U.C.C. § 9-109(2).

35. U.C.C. § 9-109(3).

36. See *infra* note 94.

37. U.C.C. § 9-313(1). Fixtures are subject to special filing provisions (§ 9-402(5)) and priority rules (§ 9-313).

38. U.C.C. § 9-203(1)(b). "Value" is defined in U.C.C. § 1-201(44).

39. U.C.C. § 9-203(1)(c).

40. U.C.C. § 9-203(1) and (2).

41. U.C.C. § 9-203(1)(a).

42. U.C.C. §§ 9-501 to 9-507.

43. U.C.C. §§ 9-503 to 9-505.

44. But see *infra* notes 311-13 and accompanying text for a discussion of the practices of certain consumer goods financiers. See also Scott, *supra* note 20, at 925 (suggesting that the conventional view of security as a priority claim to specific assets on default is unduly narrow and ignores the role of security in enhancing the success of a venture).

45. U.C.C. § 9-301(1)(b) and (3).

46. *Id.* Alternatively, an assignee for benefit of creditors or a receiver in equity are each accorded the same priority over an unperfected security interest as a trustee in bankruptcy.

47. U.C.C. § 9-301(1)(c) and (d). See also U.C.C. §§ 9-307 to 9-309, which accord certain buyers of collateral priority even over perfected security interests.

secured party whose interest in the same collateral attached previously,⁴⁸ and to any secured party who has a security interest in the same collateral and has taken the steps necessary for perfection.⁴⁹ Obviously, if the debtor has financial difficulties of any seriousness, any or all of the foregoing animals are likely to be lurking in the woods. The situation most likely to lead to default, therefore, is also the situation in which a merely "attached" security interest provides little protection to the secured party.

Any secured party with even minimal prudence, therefore, will want to take the further steps necessary to "perfect"⁵⁰ his security interest and so gain such priority over the interests of third parties as the Code permits.⁵¹ The steps which may (or must) be taken to perfect a security interest depend upon the type of collateral at issue.⁵² In the case of goods, several methods of perfection are authorized. Perhaps the easiest is the filing of a financing statement⁵³ in the appropriate records.⁵⁴ Alternatively, the secured party may perfect by taking possession of the goods subject to the security interest.⁵⁵ A purchase money security interest⁵⁶ in consumer goods⁵⁷ is perfected without filing or possession by the secured party.⁵⁸ Finally, there are more specialized provisions for filing as to fixtures⁵⁹ and for perfection as to goods in the hands of bailees.⁶⁰

The effect of perfection is to protect the security interest from encroachment by a number of the third parties who are able to prevail over a security interest which has merely attached. The secured party who perfects is no longer subordinate to an ordinary⁶¹ lien creditor.⁶² Nor need he fear the debtor's trus-

48. U.C.C. § 9-301(1)(a) and § 9-312(5)(b).

49. See U.C.C. §§ 9-301(1)(a), § 9-312(5)(a).

50. See U.C.C. § 9-303(1).

51. Of course, some third party interests will prevail over an Article 9 security interest even if the secured party perfects. See U.C.C. §§ 9-307 to 9-310. For purposes of this Article, the most important of these is the interest of the buyer of goods in the ordinary course of business. U.C.C. § 9-307(1). "Buyer in ordinary course of business" is defined in U.C.C. § 1-201(9).

52. See generally U.C.C. §§ 9-302 to 9-306, 9-313.

53. Indeed, unless one of the specifically enumerated alternate methods is used, a security interest in goods can only be perfected by filing. See U.C.C. § 9-302(1). The contents necessary for a valid financing statement are specified in U.C.C. § 9-402.

54. See U.C.C. § 9-401.

55. U.C.C. § 9-305. While the inventory of a business does not, intuitively, seem an appropriate subject for perfection by the secured party's possession, the traditional field warehousing arrangement may be seen as an attempt to extend the possessory pledge to such inventory. See 1 G. GILMORE, *supra* note 17, at §§ 6.1-6.2 at 146-54.

56. See *infra* note 91 and accompanying text for the definition of "purchase money security interest" under U.C.C. § 9-107.

57. See U.C.C. § 9-109(1) for the definition of "consumer goods."

58. See U.C.C. § 9-302(1)(d) and Official Comment 4 to § 9-302.

59. See U.C.C. §§ 9-313, 9-402(5).

60. See U.C.C. § 9-304(2), (3), and (5). Subsection (2) makes it possible to perfect a security interest in goods held by a bailee by perfecting as to a negotiable document issued by that bailee. This may be accomplished by possession of the document under § 9-305. Section 9-304(3) permits perfection as to goods held by a bailee who has not issued a negotiable document by obtaining from the bailee a nonnegotiable document in the name of the secured party, by giving appropriate notification to the bailee, or by filing. Subsection (5) provides for a 21 day period of automatic continued perfection as to goods in the hands of a bailee when the holder of a perfected, but unfilled, security interest in the goods (or a negotiable document covering them) makes the goods (or the documents covering them) available to the debtor for certain enumerated purposes.

61. The protection against lien creditors is not complete. Even a perfected security interest is subordinated to possessory mechanic's or materialmen's liens (or other statutory liens) by U.C.C. § 9-310.

tee in bankruptcy, at least to the extent the trustee's powers are dependent upon status equivalent to an ordinary lien creditor.⁶³ Some,⁶⁴ but not all,⁶⁵ buyers of the collateral are likewise removed as threats. Other secured creditors whose interests remain unperfected are now expressly subordinated,⁶⁶ and the priority between the secured creditor who perfects and other secured creditors with perfected security interests in the same collateral is governed by a series of rules set forth in U.C.C. section 9-312. The general rule, set forth in section 9-312(5)(a), accords priority among perfected security interests in order of filing or perfection (provided continuous perfection or filing is maintained); and the other subsections of section 9-312 contain exceptions to, qualifications of, or clarifications of the general rule.

It is, of course, possible under the foregoing scheme for a secured party to take and perfect a very narrow security interest in a specific item or items of collateral,⁶⁷ and, in the case of a seller financing a particular piece of heavy industrial machinery, for example, this may very well be all the secured party wants. A secured party with the inclination and the bargaining power, however, can create and perfect a security interest of dramatically expanded scope.

Specifically, one of the more significant⁶⁸ features of Article 9 is the deliberate embrace of what is often called the "floating lien" or the "blanket lien."⁶⁹

62. Since § 9-301(1)(b) subordinates only an *unperfected* security interest to lien creditors, perfection renders that section inapplicable and brings the perfected security interest back within the general validation of the security agreement "... between the parties, against purchasers of the collateral and against creditors." U.C.C. § 9-201. See 2 J. WHITE & R. SUMMERS, *UNIFORM COMMERCIAL CODE* § 26-2 at 492-95 (3d ed. 1988).

63. See 11 U.S.C. § 544(a). Of course, the trustee in bankruptcy has other ways of disturbing the sleep of even a secured party who has perfected, most notably the preference provisions of § 547(b) of the Bankruptcy Code. 11 U.S.C. § 547(b) (1976). See *infra* notes 348-50 and accompanying text. See also Chobot, *Purchase Money Security Interests: Preference Pitfalls Under the Bankruptcy Code*, 20 U.C.C. L.J. 81 (1987).

64. The class of buyers who take priority under U.C.C. § 9-301(1)(c) and (d) is eliminated for reasons parallel to those elaborated at *supra* note 62.

65. See *supra* note 51.

66. U.C.C. § 9-301(1)(a).

67. U.C.C. § 9-203 requires that a security agreement contain a description of the collateral. Official Comment 2 to § 9-203, however, makes it clear that the description need only satisfy the standard of "reasonable identification" under § 9-110, and the Official Comment to the latter section makes it clear that an itemization of the collateral is more than sufficient. Section 9-402(1), which specifies the required contents of a financing statement, authorizes a description of the collateral by item or type.

68. Validation of the floating lien was also the most controversial feature of Article 9 in the eyes of its early critics. See 1 G. GILMORE, *supra* note 17, § 11.7 at 359; Coogan, *supra* note 19, at 839.

69. 1 G. GILMORE, *supra* note 17, and Coogan, *supra* note 19, use the term "floating lien" to refer to an arrangement in which a secured party takes a security interest in all of the debtor's personal property (present and future) and fully cross-collateralizes all advances with all collateral. This also appears to be what the drafters meant by a "continuing general lien" or "floating charge." See Official Comment 2 to U.C.C. § 9-204. So used, the quoted terms are synonymous with "blanket lien." It is possible, of course, to use the term "floating lien" in a more restricted sense to refer only to the presence in a security agreement of after-acquired property and future advance clauses, without implying that all of the debtor's personal assets are encumbered. A security interest in a debtor's accounts receivable coupled with future advance and after-acquired property clauses, but not extending to his inventory or equipment, would be a "floating lien" in the second sense but not in the first. It would "float" over present and future accounts, and secure all advances, but it would not attach to inventory or equipment. Nothing is wrong with either use of the term "floating lien." In order to avoid ambiguity, however, the term will be used in this Article only in its unrestricted sense, in which it is synonymous with "blanket lien." The floating lien is thus the broadest possible form of full cross-collateralization. Professor Kripke finds the use of the term "floating lien" unfortunate. See Letter from Homer Kripke to Mark B. Wessman dated January 2, 1990, on file at the Ohio State Law Journal office. While Professor Kripke's concerns may be justified, the term is now too entrenched in the literature to abandon.

While there is no single provision authorizing the blanket lien,⁷⁰ the combined effect of several provisions makes the creation and perfection of such a lien possible.

Initially, the Code makes it possible to create a security interest in collateral without itemizing it; it is sufficient if the description of the collateral in the security agreement⁷¹ "reasonably identifies" the collateral.⁷² As a result, it is possible, in the case of collateral which consists of a large number of fungible items (*e.g.*, some kinds of business inventory) or items which turn over rapidly (*e.g.*, inventory or accounts), to create a security interest by describing the collateral as "all inventory" or "all accounts."⁷³ The financing statement used to perfect a security interest may likewise contain only a "statement indicating the types" of collateral instead of itemizing it.⁷⁴ Obviously, the availability of such generic description, coupled with the fact that the number of categories into which the Code divides collateral is relatively small, means that a secured party can create a broad security interest with fairly concise drafting.

Moreover, the Code permits the secured party great latitude in encumbering not only the debtor's current pool of assets, but his future assets as well. U.C.C. section 9-204(1)⁷⁵ allows the secured party to secure all obligations covered by the security agreement with after-acquired collateral. U.C.C. section 9-204(3)⁷⁶ then allows the "obligations covered" to include not only advances or extensions of credit made at the inception of the financing arrangement, but future advances or "value"⁷⁷ as well, even if the future advances or extensions of credit are not contemplated at the inception of the financing arrangement.⁷⁸ A well-drafted combination of a future advance clause and an after-acquired property clause effectively removes the temporal limits of the Article 9 security interest, both with respect to the debt secured and the collateral.

The provisions of the Code concerning priority as to future advances and after-acquired collateral further strengthen the secured party's position. If the secured party is the first to perfect his security interest, his interest in the initial pool of collateral is already superior to lien creditors (including the bankruptcy

70. B. CLARK, *THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* § 10.01 at 10-2 (2nd ed. 1988).

71. Such a description in a written security agreement is required by U.C.C. § 9-203(1)(a), unless the secured party takes possession of the collateral.

72. U.C.C. § 9-110. *See also* Official Comment 2 to U.C.C. § 9-203.

73. Of course, it is also *possible* to use generic descriptions to create and perfect a security interest in collateral which is neither small, fungible, nor subject to rapid replacement (*e.g.*, a large piece of industrial machinery which is part of the debtor's business equipment). In such cases, however, the secured party may have some incentive to provide a more specific description (*e.g.*, by serial number) simply in order to remove any doubt as to the identity of the collateral.

74. U.C.C. § 9-402(1).

75. *See supra* note 1.

76. *See supra* note 2.

77. The term "value" is defined at U.C.C. § 1-201(44).

78. Professor Gilmore took the position that the so-called "same class" rule qualified the potential breadth of the future advance clause. 2 G. GILMORE, *supra* note 17, § 35.5 at 932. The "same class" rule has enjoyed some success in the courts. *See* B. CLARK, *supra* note 70, ¶ 10.01[3][a]-[c] at 10-11 to 10-17. It is, however, beyond the scope of this Article. For criticism of the "same class" rule, see Campbell, *Contracts Jurisprudence and Article Nine of the Uniform Commercial Code: The Allowable Scope of Future Advance and All Obligations Clauses in Commercial Security Agreements*, 37 HASTINGS L.J. 1007 (1986).

trustee), certain classes of buyers, unperfected secured creditors, and (with some exceptions) secured creditors who perfect subsequently.⁷⁹ Moreover, assuming the usual case in which the secured party perfects by filing, his security interest in after-acquired collateral will also take priority over perfected security interests⁸⁰ arising after that of the secured party but before the debtor's acquisition of the after-acquired collateral.⁸¹ Similarly, the secured party who has perfected by filing and who makes a subsequent additional advance or extension of credit to the debtor will take priority over subsequently-filed secured parties who give value to the debtor even before the first secured party's second advance.⁸²

Finally, (and somewhat less significantly) the Code provisions on "proceeds"⁸³ contribute to the floating lien. U.C.C. section 9-306(2) permits the secured party's interest in the collateral itself to survive an unauthorized disposition by the debtor to a third party, although, if the third party is one of a variety of good faith purchasers,⁸⁴ the secured party's priority in the collateral is lost. Sections 9-306 and 9-203(3) also, however, provide for the continuation of the security interest in the proceeds of the disposition of the collateral. The interest in proceeds is easily lost if the secured party takes no further action to perfect his interest in proceeds⁸⁵ or if the proceeds are cash which is deposited in the debtor's general operating account.⁸⁶ Nevertheless, it is possible for a secured party to maintain perfected status as to proceeds if his security interest is initially perfected by filing and the proceeds are either identifiable cash proceeds⁸⁷ or are of a type which permit the secured party to attain perfected status by appropriate entries in his initial financing statement.⁸⁸

Thus, a secured party who: a) avails himself of the provisions permitting generic description of collateral in a security agreement and financing statement; b) takes and perfects a security interest in all categories of collateral permitted by the Code (including, to the extent possible, in proceeds); and c) combines a future advance clause and an after-acquired property clause so that all collateral (present and future) secures his entire debt (regardless of when

79. See *supra* text accompanying notes 61-66.

80. The statement in the text is subject to an exception for purchase money security interests. See U.C.C. § 9-312(3) and (4).

81. See Example 4, Official Comment 6 to U.C.C. § 9-312.

82. See Example 5, Official Comment 7 to U.C.C. § 9-312.

83. "Proceeds" are defined in U.C.C. § 9-306(1) as "whatever is received upon the sale, exchange, collection, or other disposition of collateral or proceeds." That section further clarifies the status of insurance payments and distinguishes "cash proceeds" and "non-cash proceeds."

84. See U.C.C. §§ 9-307 to 9-309.

85. See U.C.C. § 9-306(3)(c).

86. See U.C.C. § 9-306(3) and (4).

87. See U.C.C. § 9-306(3)(b).

88. See U.C.C. § 9-306(3)(a).

incurred), has come as close as possible⁸⁹ to encumbering all the personal property the debtor has or ever will have.⁹⁰

It is against the background of the floating lien that the privileged status of the purchase money security interest is thrown into clearest relief. U.C.C. section 9-107 defines "purchase money security interest" to permit either the seller of goods who extends credit to a buyer while reserving a security interest in the goods, or the third party lender who enables the buyer to purchase goods (commonly by a direct payment to the seller)⁹¹ to qualify as a holder of a purchase money security interest.⁹²

Moreover, the purchase money financier may, by taking appropriate steps, gain priority over any "conflicting security interest"⁹³ in the purchase money collateral. If the collateral is something other than "inventory,"⁹⁴ the purchase money financier need only have perfected his purchase money security interest at the time the debtor receives possession of the collateral or within ten days thereafter.⁹⁵ If he has done so, he has achieved priority over all other secured creditors in both the collateral and its proceeds.⁹⁶ If the collateral meets the Code definition of "inventory,"⁹⁷ the secured party must perfect before the debtor receives possession of the inventory⁹⁸ and, in addition, give notification (within the five year period before the debtor receives possession of the inven-

89. The statement in the text is qualified because, under U.C.C. § 9-304(1), a security interest in certain forms of collateral may only be perfected by the secured party's possession of the collateral. A debtor subject to a floating lien could thus presumably keep a cushion of assets by acquiring assets of the right kind. Further qualification is necessary due to the limits on the continuity of the security interest in proceeds, discussed *supra* at notes 83-88 and accompanying text; the limits on the attachment of a security interest under after-acquired property clauses to consumer goods under § 9-204(2); the purchase money priority conferred by § 9-312(3) and (4) and § 9-313(4); and specialized bankruptcy provisions, including 11 U.S.C. §§ 547, § 522(f) (1976).

90. A further aspect of the Code which makes the creation and perfection of the "floating lien" possible is the express abolition, in U.C.C. § 9-205, of the rule of *Benedict v. Ratner*, 268 U.S. 353 (1925). The *Benedict* rule is generally identified as the source of the traditional requirement that the secured party "police" the collateral. During the period of the viability of the *Benedict* rule, if a debtor under a secured financing arrangement were permitted too great a degree of control over the collateral, its disposition, or its proceeds, the financing arrangement would be held invalid as a fraud on creditors. See Official Comments 1-3 to U.C.C. § 9-205; B. CLARK, *supra* note 70, at ¶ 10.01 at 10-2 and ¶ 10.01[4] at 10-18 to 10-20; 1 G. GILMORE, *supra* note 17, §§ 11.6—11.7 at 354-65; Coogan, *supra* note 19, at 853-54.

91. It has been suggested that a third party lender who wishes to attain the status of purchase money financier of goods should pay the seller directly or make his check jointly payable to the debtor and the seller. The reason is that the lender must be able to show that the value he gave to enable the debtor to acquire rights in the collateral was "in fact so used." See, e.g., B. CLARK, *supra* note 70, at ¶ 3.09[2][a] at 3-94; 2 J. WHITE & R. SUMMERS, *supra* note 62, at § 26-5 at 506; McLaughlin, *Qualifying as a Third-Party Purchase Money Financier: The Hurdles to Be Cleared, the Advantages to Be Gained*, 13 U.C.C. L.J. 225, 230-31, 247 (1981).

92. Further discussion of the technical requirements of U.C.C. § 9-107 is postponed until development of the arguments for and against allowing a purchase money financier to cross-collateralize, *infra* note 203 and accompanying text.

93. The quoted phrase is used in both U.C.C. § 9-312(3) and (4).

94. Goods are classified as "inventory" under U.C.C. § 9-109(4) "if they are held by a person who holds them for sale or lease or to be furnished under contracts of service or if he has so furnished them, or if they are raw materials, work in progress or materials used or consumed in a business. Inventory of a person is not to be classified as his equipment." *Id.*

95. See U.C.C. § 9-312(4).

96. *Id.*

97. See *supra* note 94.

98. See U.C.C. § 9-312(3)(a).

tory) to any rival⁹⁹ inventory financier who has filed before the purchase money financier files¹⁰⁰ or before the twenty-one day period of temporary perfection of the purchase money security interest under U.C.C. section 9-304(5).¹⁰¹ The notification must state that the purchase money secured party has acquired or expects to acquire a purchase money security interest in the debtor's inventory, and it must describe the inventory "by item or type."¹⁰² If the purchase money inventory financier clears these hurdles, he has priority over other secured creditors as to the inventory collateral and as to identifiable cash proceeds received by the debtor before the debtor delivers under a resale contract.¹⁰³

Thus, the purchase money secured party has the power to "prime" any conflicting security interest, including a perfected one claimed under the after-acquired property clause¹⁰⁴ of a prior secured creditor.¹⁰⁵ This effectively confers the power to prevail, as to purchase money collateral, even over the rather awesome scope of a previously perfected floating lien. Indeed, it is one of the few ways to do so.¹⁰⁶ That feature of the purchase money security interest is the key to its conventional justification.

B. *The Justification for Purchase Money Superpriority*

1. *The Conventional View: Breaking the Stranglehold*

Probably the most common justification given for the extraordinary priority accorded the purchase money security interest rests, at bottom, on a concern for the potential abuse of the floating lien. A properly perfected floating lienor has

99. Technically, the notification must be sent to any holder of a conflicting security interest who has "filed a financing statement covering the same types of inventory" before the specified times. U.C.C. § 9-312(3)(b).

100. See B. CLARK, *supra* note 70, at ¶ 3.09[3][a] at 3-102 to 3-103 (discussion and resolution of possible ambiguity in the language of U.C.C. § 9-312(3)(b)).

101. See U.C.C. § 9-312(3)(b)-(d).

102. U.C.C. § 9-312(3)(d).

103. It will be observed at once that the purchase money inventory financier's protection as to proceeds is narrower than the protection afforded the non-inventory purchase money financier. A credit sale of inventory by the debtor will typically create either an "account" under U.C.C. § 9-106 or "chattel paper" under U.C.C. § 9-105 (1)(b), and the priority of the purchase money inventory financier's security interest will not be preserved under § 9-312(3). The inventory financier's loss of priority as to accounts was a result of a deliberate decision to favor an accounts receivable financier claiming under an after-acquired property clause. See Official Comment 3 to U.C.C. § 9-312; 2 J. WHITE & R. SUMMERS, *supra* note 62, at § 26.4 at 501-03. See also *M Bank Alamo Nat. Ass'n v. Raytheon Co.*, 886 F.2d 1449 (5th Cir. 1989). The inventory financier's loss of priority as to chattel paper follows from the language of § 9-312(3), and the priority of a purchaser of the chattel paper in the ordinary course of business is established by § 9-308(b). See *Aetna Finance Co. v. Hendrickson*, 526 N.E.2d 1222, 6 U.C.C. Rep. Serv. 2d 1610 (Ind. App. 1988); *Borg-Warner Acceptance Corp. v. C.I.T. Corp.*, 679 S.W.2d 140, 39 U.C.C. Rep. Serv. 1864 (Tex. App. 1984). As cash sales of inventory are now the exception rather than the rule, the loss of purchase money priority as to proceeds of inventory in the form of accounts and chattel paper is a significant limitation on the purchase money superpriority. Some floor plan financiers avoid the problem as to chattel paper by financing the retail sale (and thus holding the chattel paper) as well as the dealer's inventory acquisitions. See B. CLARK, *supra* note 70, at ¶ 10.05[3] at 10-50 to 10-51.

104. See Official Comment 1 to U.C.C. § 9-107; Official Comment 3 to U.C.C. § 9-312; Example 4, Official Comment 6 to U.C.C. § 9-312.

105. Nor does it matter if the purchase money secured party knows of the prior security interest. Indeed, the purchase money inventory financier must know of all previous security interests perfected by filing if he is to give the notice required under U.C.C. § 9-312(3).

106. Another way is the execution of a subordination agreement under U.C.C. § 9-316, see *infra* notes 318-20 and accompanying text.

a first priority position with respect to virtually all the debtor's personal property.¹⁰⁷ An ordinary secured lender therefore has a reduced incentive to lend to a debtor already subject to a floating lien, since the best priority position the conventional security interest of the new lender can occupy is second in rank and, in the event of default or insolvency of the debtor, the floating lienor's debt¹⁰⁸ will be satisfied in full before any assets may be applied to the new lender's debt. The debtor may therefore find himself in the uncomfortable position of having no source of new credit alternative to the floating lienor. If the floating lienor then declines to extend further credit, the debtor is significantly impaired in his ability to acquire fresh assets, absent some device other than an ordinary security interest subject to the ordinary "first to file or perfect" rule of priority.¹⁰⁹ The purpose of the purchase money security interest is to enable the debtor and a new lender to break the stranglehold of the floating lienor and thus enable the debtor to acquire fresh assets.¹¹⁰ By following the steps outlined in U.C.C. section 9-312(3) or (4), as appropriate, the new lender is able to take priority over the interest in the purchase money collateral which the floating lienor acquires by virtue of his after-acquired property clause. Moreover, because of the requirement of U.C.C. section 9-107 that the purchase money advance enable the debtor to acquire rights in the collateral, the new extension of credit or advance adds a specific asset or assets to the debtor's estate.¹¹¹

2. *The Fairness Rationale*

Professor Lloyd recognizes the foregoing "stranglehold" rationale as at least part of the basis for the Code's purchase money superpriority.¹¹² Yet he seems to regard it as an incomplete explanation or, more precisely, a single

107. See *supra* notes 68-90 and accompanying text.

108. Indeed, the floating lienor can make new advances after the new lender makes his loan, and the floating lienor takes priority with respect to the last advances as well as those made before the new lender entered the picture. See Example 4 in Official Comment 6 to U.C.C. § 9-312.

109. See U.C.C. § 9-312(5).

110. For variants of the rationale summarized in the text, see 2 J. WHITE & R. SUMMERS, *supra* note 62, at § 26-5 at 504; B. CLARK, *supra* note 70, at ¶ 3.09[1] at 3-93; McLaughlin, "Add On" Clauses in Equipment Purchase Money Financing: Too Much of a Good Thing, 49 FORDHAM L. REV. 661, 670-71 (1981); Lloyd, *supra* note 8 at 5; *M Bank Alamo Nat. Ass'n v. Raytheon Co.*, 886 F.2d 1449, 1452 (5th Cir. 1989); *ITT Diversified Credit Corp. v. Daniels (In re Daniels)*, 35 Bankr. 247, 249-50, 37 U.C.C. Rep. Serv. 967 (Bankr. W. D. Okla. 1983); *In re Gibson*, 16 Bankr. 257, 265, 33 U.C.C. Rep. Serv. 77 (Bankr. D. Kans. 1981); *Wade Credit Corp. v. Borg-Warner Acceptance Corp.*, 83 Or. App. 479, 732 P.2d 76, 3 U.C.C. Rep. Serv. 2d 289 (1987); *Greg Restaurant Equipment & Supplies, Inc. v. Valway*, 144 Vt. 59, 472 A.2d 1241, 38 U.C.C. Rep. Serv. 1053 (Vt. 1984).

111. Professor Scott rejects the conventional justification for purchase priority as stated in the text and offers instead what he characterizes as a consistent but more rigorous statement of it. Under Scott's relational model of secured financing, once the creditor's rate of return is fixed by agreement, the interests of the debtor and secured creditor diverge to some extent. Specifically the debtor has a greater incentive than the creditor to pursue high-risk, high return opportunities which arise after the opportunity which led to the establishment of the financing relationship initially. The creditor's "conservatism" in adhering to the development plan for the original project may be inconsistent with maximizing the value of the debtor firm. Permitting the debtor to grant a second financier purchase money priority is one way of controlling such excess conservatism, and it is likely to be less costly than alternative control methods (e.g., debtor "monitoring" of the creditor or the debtor's exercise of a right to terminate the financing relationship). Accordingly, a rational debtor and a rational creditor might agree in advance to permit the debtor to confer purchase money priority to a second financier in order to enable the debtor to pursue new opportunities with a positive value to the firm. See Scott, *supra* note 20, at 962-63.

112. Lloyd, *supra* note 8, at 5.

instance of a broader principle according privileged status to purchase money debt—a principle not tied to any particular financing device or context. That broader principle is the “inherent fairness of giving first claim to the assets to those who parted with their money to make possible the assets’ acquisition.”¹¹³

Lloyd’s method of justifying this broader principle of fairness¹¹⁴ is historical rather than philosophical. That is, he does not attempt to demonstrate, as a matter of philosophical or political theory, that it is inherently fair to reward the enabling lender or seller with the first claim to the assets acquired by the debtor with the enabling advance or extension of credit.¹¹⁵ Rather, through an analysis of the common law origins and development of the purchase money superpriority and other privileges accorded purchase money debt, he endeavors to show that such a principle of fairness is embedded in doctrine developed in a variety of different contexts, including both real estate and personal property law.

In tracing the 300-year history of the privileged status of purchase money debt, Lloyd relies principally on the following observations. First, the evolution of the purchase money superpriority in real estate law exhibited a marked tendency to preserve the priority in the face of defects in contemporaneous technical theories.¹¹⁶ The priority of the purchase money real estate mortgage was originally supported by the theory of “instantaneous seisin,” the notion that the mortgagor parted with seisin the instant he acquired it.¹¹⁷ The theory that seisin whisked off to the mortgagee as soon as it arrived at the mortgagor’s (and thus could not become subject to other liens on, or debts of, the mortgagor) could not, however, account for cases of purchase money mortgages in which the mortgagor’s acquisition of title and his grant of the mortgage to his lender or seller were separated in time.¹¹⁸ Rather than abandon the purchase money superpriority, however, the courts simply created new technical theories to support it, including the “continuous transaction theory”¹¹⁹ and the “pre-existing lien” theory.¹²⁰ Further defects in those theories,¹²¹ however, did not result in

113. *Id.* at 11.

114. Lloyd’s fairness principle focuses on fairness to the purchase money creditor. Others have emphasized an apparently complementary fairness principle: the proposition that because the purchase money creditor finances new assets, his priority takes nothing from other creditors because the latter could not have relied upon the fresh assets in extending credit. See Stilson, *The “Overloaded” PMSI in Bankruptcy: A Problem in Search of a Resolution*, 60 TEMP. L.Q. 1, 16 (1987). Aronov, *The Transformation Rule Applied to Purchase Money Security Interests in Commercial Lending Transactions*, 16 MEM. ST. U.L. REV. 15, 19 (1985).

115. The statement in the text is not intended as a criticism. Aside from the intuitive plausibility of Lloyd’s claim of fairness, it is a respectable form of legal justification to show that a particular principle is the basis for a broad spectrum of particular legal rules or decisions and so may not be disregarded without calling an imposing edifice of doctrine into question. Perhaps the most familiar example of such an approach is Fuller & Perdue, *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52 (1936).

116. Lloyd, *supra* note 8, at 16.

117. Lloyd, *supra* note 8, at 11-12.

118. Lloyd, *supra* note 8, at 12-13. Other difficulties with the instantaneous seisin theory include its incompatibility with the rather popular lien theory of mortgages, and its inability to explain the lack of purchase money priority in cases in which delivery of a deed to the mortgagor and his delivery of a mortgage is, in fact, simultaneous, but the mortgagee’s funds are not used, or are only partially used, for the purchase of the property. *Id.* at 14-15.

119. Lloyd, *supra* note 8, at 13.

120. Lloyd, *supra* note 8, at 15.

the disappearance of the privileged status of purchase money debt. Rather, the courts protected purchase money debt by bending the technical theories, an indication that the true basis of the purchase money superpriority is the nature of the debt itself.¹²²

Second, again in the context of real estate law, the claim of a purchase money lender or seller has always enjoyed priority over the debtor's claim of homestead exemption.¹²³ More importantly, the purchase money creditor's priority did not even require that the purchase money debt be secured; the privileged status of purchase money debt was independent of the nature, or even the presence, of a security device.¹²⁴ This, in Lloyd's view, further supports the contention that purchase money priority is grounded in the fairness rationale.¹²⁵

Third, the same evolutionary pattern noted in the real property cases—a tendency to preserve purchase money priority in the face of technical defects in the theories initially marshalled in its support—recurs in the evolution of purchase money priority under the pre-Code chattel mortgage and conditional sale devices.¹²⁶ Fourth, the courts generally treated the statutory homestead exemption cases involving purchase money priority as authority in common-law purchase money financing cases (and vice-versa),¹²⁷ and likewise treated real property cases involving the purchase money priority as authority for similar priority in personal property cases, and vice-versa.¹²⁸ Again, the inference is that similar considerations of fairness are the basis of the priority in all types of cases, and differences in the type of property encumbered or in the technical requirements of the security device used are not material.

Finally, Lloyd notes that, in both real property and pre-Code personal property cases, the refinancing of purchase money debt, or its consolidation or commingling with non-purchase money debt, did not extinguish the priority of, at the very least, the portion of the resulting debt which could be attributed to the original purchase money obligation through normal tracing rules.¹²⁹ The collective effect of the historical trends noted is to illustrate that the true basis for the preferred status of purchase money debt is something deeper than the shifting technical reasons often appearing in reported cases.¹³⁰ That basis is a recognition, explicit in earlier cases but often forgotten in later cases, that it is fair to award first claim to an asset to the creditor without whose help the debtor would never have had it in the first instance.¹³¹

121. The defect in the "continuous transaction theory," is that it is not a theory at all. It is merely an expression of an intent to loosen the technical restrictions of the instantaneous seisin theory. Lloyd, *supra* note 8, at 13. The principal defect of the "pre-existing lien" theory is its inability to explain why the third party enabling lender is accorded purchase money priority. *Id.* at 16.

122. *Id.* at 16.

123. *Id.* at 17.

124. *Id.*

125. *Id.* at 17-18.

126. *Id.* at 19-30, 37.

127. *Id.* at 18-19.

128. *Id.* at 22.

129. *Id.* at 26-37.

130. *Id.* at 37.

131. *Id.* It is, of course, possible to question the claim that such an allocation is truly fair. Particularly, if the debtor is insolvent, it is possible to argue that all creditors should *prima facie* share the cost of the debtor's failure,

3. *Law and Economics: The Situational Monopoly*

Professor Lloyd thus explains purchase money priority in terms of a moral principle of fairness and attempts to support that principle with historical data. A fundamentally different approach is taken by Professors Jackson and Kronman in an influential article,¹³² if not an entirely uncontroversial one.¹³³ It

and that there is no reason to favor the secured creditor who can trace his advance to the acquisition of a tangible asset over another secured creditor, or even an unsecured creditor, since the latter have, at some point, likewise contributed to the debtor's estate. Pushed to its logical conclusion, however, such an argument calls into question the justification for any system of secured debt. *See, e.g.,* Scott, *supra* note 20, at 901 (suggesting that in the absence of an efficiency justification for secured debt, normative goals would dictate conceiving business failure as a common disaster in which all creditors are treated equally); White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473, 475 (1984) (suggesting that, in the absence of an efficiency justification for secured debt, traditional notions of fairness and concern for the underdog would dictate that secured creditors not be treated better than general creditors). While the justifiability of secured debt is the subject of vigorous debate among economists, *see infra* notes 133-72 and accompanying text, it is, as a political matter, settled by the long history of security devices and the widespread enactment of Article 9.

132. Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979).

133. Perhaps the sharpest response came from Professor Kripke, who questions the entire law and economics approach to commercial law. *See* Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929 (1985). Professor Kripke's own approach is more empirical, and he offers an explanation of secured credit in terms of its role in the distribution of goods. *Id.* *See also* Phillips, *The Commercial Culpability Scale*, 92 YALE L.J. 228 (1982) (explaining a variety of U.C.C. risk allocations in terms of a four-level scale of increasingly culpable mental states, only the lowest level of which appeals to economic consideration of cost avoidance); Carlson, *Rationality, Accident, and Priority Under Article 9 of the Uniform Commercial Code*, 71 MINN. L. REV. 207 (1986) (explaining certain features of the Article 9 priority system as the product of a drafting error). Even among those who agree that the economic analysis of secured credit offers the most promising justification, there is substantial disagreement as to the precise nature of that justification. Alternatives to the Jackson-Kronman analysis presented in the text include Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982) (explanation of Article 9 priorities lies in the phenomenon of differential monitoring costs and the freerider problem; where the debtor's assets provide convenient "focal points" for monitoring the debtor for misbehavior in the form of asset substitution or risk alteration, the most efficient monitors do so and take security as compensation for solving the problem of over- or under-monitoring created by freeriding; where focal points are not present, most efficient monitors are unsecured and take rewards in the form of interest premiums above monitoring costs); White, *supra* note 131 (security lowers total credit bill by overcoming risk aversion of some creditor firms or of the employees of potential creditor firms); Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986) (explanation of secured credit in terms of overall reduced screening costs and decreased costs associated with the debtor's adverse incentive, once debt is incurred, to prefer investments with higher than optimal risk); Scott, *supra* note 20 (explanation of secured financing in terms of financing firm-specific growth opportunities by "relational lender," who takes floating lien in all assets associated with the venture and insists on exclusive financing; utility of such arrangements consists of ability to control debtor misbehavior (including the familiar risks of conversion, asset substitution, and dilution, as well as the risk the debtor will underdevelop the subject investment opportunity), as well as external benefits of financial management and coordinated monitoring); Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989) (explanation of secured credit by relaxation of economists' assumptions of complete risk neutrality, costless contracting, and resulting reduction of unnecessary risk premiums and increased borrowing capability when secured debt is issued). *But see* Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUDIES 1 (1981) and Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984) (both suggesting that current theories fall short of an efficiency-based explanation of secured debt). The Jackson-Kronman model has been selected for expositon in the text, not because it commands universal assent, but because a) it offers the most distinctive and articulated explanation of purchase money priority in particular, and b) it is the only model with any apparent implications for the debate over cross-collateralization. *See infra* text accompanying notes 158-69, 267-68. *See also* the Scott economic variant of the conventional justification discussed *supra* at note 111. Buckley questions the justifiability of a mandatory purchase money priority. Buckley, *supra* at 1461-66. *But see* Shupack, *Defending Purchase Money Security Interests Under Article 9 of the U.C.C. From Professor Buckley*, 22 IND. L. REV. 777 (1989) (defending mandatory purchase money superpriority against an alternate regime of free contract on grounds of the probable preferences of contracting parties, probable savings in drafting, search, and collateral realization costs, and allocation of debtor misbehavior risks to the party best able to bear them). Levmore and Scott (in an alternative hypothesis) explain the purchase

is their announced goal to give a theoretical explanation¹³⁴ of the existence of secured debt as a whole and then fit the privileged position of purchase money debt within that general theoretical framework.¹³⁵

The phenomenon to be explained is why a debtor and his creditors would agree to a system in which a debtor may, by agreement with one creditor, give that creditor a first claim to specific assets in the debtor's estate, so that those assets are applied to the preferred creditor's claim before other (unsecured) creditors have any claim to them at all. The answer cannot be the simple one, *i.e.*, that by dedicating a portion of the debtor's estate to his claim, a creditor reduces the risk of nonpayment and so reduces the price of his loan.¹³⁶ In a competitive credit market (and in the absence of transaction costs) the reduced risk of nonpayment produced for one creditor by taking security is entirely offset by the increased risk of nonpayment to other creditors, who now effectively have a smaller pool of assets from which to satisfy their claims.¹³⁷ The other creditors must therefore charge higher interest rates. The overall cost of credit to the debtor, and the joint sum of costs and benefits to the debtor and all his creditors, is therefore the same for a system of secured credit as for one which does not permit it.¹³⁸ Since the creation of a security interest entails certain transaction costs, it would seem to follow that no rational debtor and creditor would agree to it.

The key to explaining the existence and utility of secured debt is the introduction of transaction costs into the analysis.¹³⁹ One aspect of a creditor's nonpayment risk is the "threat of debtor misbehavior," *i.e.*, the fact that, once a loan is made at a particular interest rate, the debtor has an incentive to engage in behavior which increases the creditor's risk of nonpayment since, by doing so, the debtor obtains a higher risk loan at the price of a lower risk loan.¹⁴⁰ The creditor can respond to the risk of debtor misbehavior either by raising his rate of interest or by "monitoring" or "policing" the debtor's financial affairs, assets,

money priority in terms of efficiencies generated by specialized monitoring ability, an explanation which is not different in kind from the general justification of secured credit. Levmore, *supra* at 57; Scott, *supra* note 20, at 963.

134. Jackson & Kronman eschew any attempt to provide an explanation based on moral principles of fairness. They refer briefly to the argument, sometimes raised in the bankruptcy context, that it is inherently unfair to permit a debtor to create secured debt at all, and so to prefer one creditor over another otherwise equally deserving. Jackson & Kronman, *supra* note 132, at 1147. Their response is that, so long as a) all borrowing and lending transactions are voluntary, b) each creditor remains free to set the terms upon which he will lend, and c) each creditor is aware of the range of terms that can be included in the loan agreements of others, there can be no moral objection if one creditor fares better than another in the event of the debtor's insolvency. *Id.* at 1147-49. From the perspective of fairness, they conclude, a system in which secured debt is permitted is neither inferior nor superior to one in which it is not permitted. *Id.* at 1148-49. The proper explanatory task, therefore, is not to explain why secured debt in general, or purchase money priority in particular, is morally preferable, but why it is economically advantageous. *Id.* at 1149.

135. See Jackson & Kronman, *supra* note 132, at 1146.

136. *Id.* at 1149, 1153.

137. *Id.* at 1154-55. The only economic theorist who questions this thesis is White, *supra* note 131, at 481-89. He hypothesizes that, because bankruptcy costs other than the shares of secured creditors deprive unsecured creditors of any distribution in bankruptcy, the latter may be indifferent to the issuance of secured debt.

138. See *id.* at 1155.

139. *Id.* at 1155.

140. See *id.* at 1149-50.

and conduct subsequent to the making of the loan—or by some combination of both strategies.¹⁴¹ The loan price will thus reflect the cost of whatever monitoring the creditor decides to do (or impose on the debtor) plus his assessment of the risk of nonpayment (including that resulting from debtor misbehavior) which remains despite monitoring.¹⁴² By taking a specific asset or assets as security, however, a creditor may be able to reduce both the risk of nonpayment (because a specific portion of the debtor's estate is allocated to him) and his monitoring costs (because he can focus his monitoring on a discrete portion of the debtor's estate).¹⁴³ To be sure, the reduced risk and monitoring cost to the first creditor may be assumed to result in an increased risk of nonpayment and/or increased monitoring costs for other creditors.¹⁴⁴ However, the reduction of the first creditor's risk and monitoring cost may be greater than the corresponding increase, producing an overall joint savings to be shared between the debtor and his creditors.¹⁴⁵ This may occur because the other creditors can monitor more cheaply than the first or think it less important to monitor.¹⁴⁶ Moreover, if different creditors are granted security interests, but in different assets, further savings may result from the ability of each to focus his monitoring on specific assets.¹⁴⁷

141. Monitoring or policing can take the form of direct observation or verification by the creditor himself, or of imposition of reporting or other requirements on the debtor, or some mix of the two. See Jackson & Kronman, *supra* note 132, at 1150-51.

142. *Id.* at 1150-52.

143. *Id.* at 1152-53.

144. *Id.* at 1154.

145. *Id.* at 1154-56.

146. *Id.* at 1155 & n.47. The resulting prediction that the most efficient monitors remain unsecured while the least efficient monitors take security has been the focus of substantial criticism. See Schwartz, *Current Theories*, *supra* note 133, at 11 & n.28; Levmore, *supra* note 133, at 53; Scott, *supra* note 20, at 909-10. Schwartz and Levmore both make the point that, in fact, unsecured creditors (such as employees or trade creditors) are often less able monitors than banks, who are often secured.

Levmore argues that the Jackson-Kronman model fails to take into account the problem of freeriding. Because monitoring may benefit more than one creditor, the potential for freeriding creates risks of duplicate monitoring, on the one hand, or less than optimal monitoring on the other. Levmore suggests this problem is solved if the debtor has assets which constitute good "focal points" for monitoring. If so, a security interest in the focal point can be assigned to the most efficient monitor, who is rewarded with a priority interest and reduced risk, while other creditors may avoid duplicate monitoring. The purchase money priority is simply an instance of a priority assignment to a particularly talented class of monitors, commercial lenders and sellers of assets. Where no such focal point exists, the most efficient monitors remain unsecured, taking their rewards in the form of interest rate premiums in excess of their monitoring costs. Article 9 thus fosters a "mixed monitoring system." See Levmore, *supra* note 133, at 55-59. The Jackson-Kronman model was refined and further articulated subsequently by Professor Jackson to take account of Levmore's "mixed monitoring" hypothesis. See D. BAIRD & T. JACKSON, *CASES, PROBLEMS AND MATERIALS ON SECURITY INTERESTS IN PERSONAL PROPERTY* 324-28 (2d ed. 1987). See also Scott, *supra* note 20, at 909. Nevertheless, explanation of secured debt solely in terms of rate reductions due to differential monitoring costs is still not satisfactory to Scott, *supra* note 20 at 908-12, 925-26, Schwartz, *Continuing Puzzle*, *supra* note 133, at 1055-59; *Current Theories*, *supra* note 133, at 9-14 or Buckley, *supra* note 133, at 1441-45.

147. See Jackson & Kronman, *supra* note 132, at 1154, & n.45. Thus, a debtor and his creditors might have an incentive to agree to the subordination of one creditor to another rather than allowing all creditors a pro rata claim to the debtor's entire estate. *Id.* at 1157. Permitting the debtor to grant such a preference by agreement with the preferred creditor (rather than by consent of all creditors) is then justified by the avoidance of the freerider and holdout difficulties inherent in any situation in which the unanimous agreement of multiple parties is required. *Id.*

Jackson and Kronman proceed to an economic explanation of the rules which govern priority between secured creditors in the same collateral.¹⁴⁸ The general rule in U.C.C. section 9-312(5), according priority to the first secured creditor to file or perfect, is supported as a rule necessary to capture the efficiencies made possible by a system of secured financing.¹⁴⁹ The "first to file or perfect" rule is characterized as a variant of the traditional pre-Code "first in time, first in right" priority principle.¹⁵⁰ To see why such a rule is necessary to secured financing, it is only necessary to consider the effect of a contrary rule. A "last in time, first in right" rule would permit a debtor who had granted a first creditor a security interest in specific collateral to grant a second creditor an overriding priority in the same collateral.¹⁵¹ Moreover, once the first creditor's loan was made, the debtor would have an incentive to grant such overriding priority to a second creditor. Doing so would increase the riskiness of the first creditor's loan, at no additional cost to the debtor, and is thus simply a form of "debtor misbehavior."¹⁵² Since the first creditor's loan thus may be rendered at least partially unsecured, and the debtor has an incentive to make it unsecured, no rational first creditor would ever lend at any rate other than the rate he would charge for a totally unsecured loan.¹⁵³ The cost reductions associated with a system of secured financing would never be realized.¹⁵⁴ Thus, if there is any incentive for a debtor and his creditors to agree to a system of secured financing, there is also an incentive to adopt a version of the "first in time, first in right" principle.

Further, there is also an incentive to adopt the equivalent of the Code's rule authorizing the use of the after-acquired property clause.¹⁵⁵ Indeed, an after-acquired property clause is a rather straightforward transaction cost saving device. If collateral is of a type (such as inventory or accounts receivable) which turns over very quickly, a single agreement with an after-acquired property clause is much cheaper than the expense of negotiating and documenting a new contract each time collateral is disposed of and replaced.¹⁵⁶

It is against this background of an economic explanation of a system of secured credit containing a "first in time, first in right" general priority rule and an express authorization of after-acquired property clauses that the explanation

148. See Jackson & Kronman, *supra* note 132, at 1161.

149. *Id.* at 1162.

150. *Id.* at 1162. But see Carlson, *supra* note 133, at 212, 215-17, 223-33 (distinguishing strict "first in time" rule from notice, race, and race-notice priority schemes and classifying the Article 9 scheme as partly race and partly notice or race-notice).

151. *Id.* at 1163.

152. *Id.* at 1163, 1149-50.

153. *Id.* at 1163.

154. *Id.*

155. *Id.* at 1167.

156. *Id.* at 1167. Professor Scott's relational model accords the floating lien a much larger explanatory role than the Jackson-Kronman model assigns to the after-acquired property clause. Scott argues that the floating lien, coupled with an exclusive financing arrangement, gives the relational financier sufficient leverage over the debtor to control all four major types of debtor misbehavior (conversion, asset substitution, dilution, and most importantly, underinvestment of effort or resources in the project financed), serves as a bonding device, and has external benefits in the form of the relational financier's superior financial management and the facilitation of coordinated monitoring. See Scott, *supra* note 20, at 925-33.

of the purchase money priority may finally emerge. The exceptional priority accorded a purchase money security interest is necessary in order to ameliorate one undesirable effect of the after-acquired property clause.¹⁵⁷

More specifically, a secured creditor who has priority over others under the "first in time, first in right" rule and who has the benefit of an after-acquired property clause has a "situational monopoly" with respect to future borrowings by the same debtor against collateral of the same type.¹⁵⁸ That is, absent some device like the purchase money security interest, he enjoys a built-in advantage over other creditors in bidding for the debtor's future business.¹⁵⁹ The first creditor's advantage consists of lower additional monitoring costs incident to the second loan.¹⁶⁰

This situational monopoly may be avoided or ameliorated in one of several ways. The most obvious is to avoid the after-acquired property clause, but that is a sacrifice of the transaction cost savings such clauses entail.¹⁶¹ Another is for the debtor and the first priority creditor to include an after-acquired property clause in their agreement but to negotiate a reduction in the price of the initial loan sufficient to offset the anticipated monopoly premium.¹⁶² The costs associated with such a negotiating process may be significant, however, because anticipating the size of the premium may very well turn on difficult estimates of the frequency of future credit extensions and the relative bargaining strength each party is likely to have in subsequent negotiations.¹⁶³

The final, and best, alternative is the development of a purchase money priority which enables a second creditor to take a first lien on newly-acquired collateral, effectively overriding the initial secured creditor's after-acquired property clause.¹⁶⁴ The purchase money priority enables the purchase money creditor to confine his incremental monitoring to the new collateral, thus bringing his bid on the new loan closer to that of the first creditor.¹⁶⁵ Moreover,

157. See Jackson & Kronman, *supra* note 132, at 1167-75.

158. See *id.* at 1167.

159. *Id.*

160. *Id.* at 1170-71. Jackson and Kronman provide an example using two creditors, C1 and C2. C1 has a first priority security interest in \$10,000 worth of the debtor's inventory. His security agreement contains an after-acquired property clause. If the debtor decides to borrow an additional \$1000 to buy new inventory, the best the other creditor, C2, can hope for is a second priority lien on the new and old inventory, since C1 is perfected as to both by virtue of his after-acquired property clause. Moreover, C2 must factor into his price calculation for the new loan not only the cost of monitoring the new inventory, but of monitoring the old. This need results from two factors: 1) the fact that C1 may dip into the new inventory to satisfy his claim in the event the old inventory proves insufficient; and 2) the fact that, once the second loan is made by C2, the debtor has the usual incentive to engage in "debtor misbehavior," this time in the form of collusion with C1 to increase the riskiness of C2's loan, as long as C1's secured position is not affected. If C1 makes the loan, however, his costs of monitoring the old inventory are sunk. They presumably were considered in setting the price of the first loan. His incremental monitoring costs, therefore, are only those associated with monitoring the new inventory, and he thus can underbid C2. *Id.* at 1168-71. Presumably, C1 can extract a premium from the debtor by underbidding C2 by an amount less than the difference between C1's and C2's incremental monitoring costs.

161. See *id.* at 1167, 1173.

162. See *id.* at 1171.

163. See *id.* at 1171-72, 1173.

164. See *id.* at 1172.

165. To return to the example discussed *supra* note 160, if C2 is given purchase money priority in the new inventory, he may confine his monitoring to the new inventory and his incremental monitoring costs are therefore closer to C1's. *Id.* at 1172-73. The purchase money security interest is said to "blunt" the floating lienor's situa-

although the price of a loan with only an after-acquired property clause would (assuming a competitive credit market) be lower than one which also contained an authorization for purchase money priority,¹⁶⁶ the inclusion of the purchase money provision eliminates the lengthy and expensive negotiation costs necessary to arrive at that lower price.¹⁶⁷ Thus, when the opportunity to reduce transaction costs makes an after-acquired property clause independently desirable, a purchase money priority provision is likely to be advantageous as well.¹⁶⁸ Writing the purchase money priority into Article 9 thus simply reproduces the result to which rational parties would agree.¹⁶⁹

One caveat is necessary. The purchase money priority must not be a blanket authorization for the purchase money creditor to override a prior nonpurchase money secured creditor's priority in the entire pool of the debtor's assets. If it were, it would permit the purchase money creditor to subordinate the first creditor's interest even in assets available to the first creditor as collateral at the time of the initial loan.¹⁷⁰ If so, the purchase money priority would be equivalent to the "last in time, first in right" rule, and, under such a rule, a system of secured credit is impossible because no lender will lend at any less than the rate for an unsecured loan.¹⁷¹ Thus, in order to maintain the minimal conditions for a system of secured financing (and the transaction cost savings it entails), the purchase money override must be confined to identifiable new assets demonstrably acquired with the purchase money loan.¹⁷²

tional monopoly, but not to eliminate it, because creation of a purchase money security interest requires the purchase money creditor to incur transaction costs to which the prior floating lienor is not subject, and because the purchase money security interest does not eliminate certain informational advantages the floating lienor may enjoy simply because he has already incurred the start-up costs involved in establishing a lending relationship. *Id.* at 1172, 1174-75 and nns.92 & 94.

166. *Id.* at 1173.

167. *Id.* In Professor Scott's view, the Jackson-Kronman explanation of purchase money priority falters at this point. Scott contends that the value of purchase money priority is inherently unpredictable since it depends on the success of the financing venture, and that, the hypothetical "creditors bargain" posited by Jackson and Kronman would not be reached. *See* Scott, *supra* note 20, at 962. Scott offers two alternative explanatory hypotheses for the purchase money priority. The first is that it functions as an escape hatch from the relational lender's excessive post-loan conservatism. *See supra* note 111. The second is that typical purchase money creditors have specialized knowledge of particular kinds of assets and frequent contact with the debtor for maintenance, service, etc.; they may therefore be able to monitor for asset substitutions or conversions at a lower cost than other creditors. Scott, *supra* note 20, at 963. The second hypothesis resembles Levmore's explanation of purchase money priority. Levmore, *supra* note 133, at 56-57.

168. Jackson & Kronman, *supra* note 132, at 1173.

169. *Id.*

170. *Id.* at 1176.

171. *Id.* at 1176, 1162-64.

172. *Id.* at 1177. Jackson and Kronman refer to this requirement as a "tracing" requirement. *See id.* at 1145-46 & n.11. The term "tracing" is also used to describe the rules or process by which a debtor's payments are allocated to debts incurred at different times with the same creditor. *See* Lloyd, *supra* note 8 at 86-87. In order to avoid ambiguity, the term "tracing" will be confined to the latter use in this Article, and the Jackson-Kronman usage will be avoided.

II. THREE PARADIGMS OF PURCHASE MONEY INVENTORY FINANCING

A. Introduction

In the preceding section, the key features of, and the most popular justifications for, the purchase money priority were summarized. It is therefore possible to turn to the primary task of this article—the determination whether any degree of cross-collateralization is compatible with the rules governing the purchase money security interest and the policies supporting those rules.

The analytical tool for pursuing that question is a set of three possible purchase money inventory financing paradigms, the last of which has two variants. In each case, the reader is asked to assume that, prior to any contact between the debtor and a purchase money financier, the debtor has already obtained a start-up or operating loan from the Bucolic Bank ("Bucolic"), which may from time to time make further extensions of credit. Further, it should be assumed in each case that a security agreement and related documentation between the debtor and Bucolic gives Bucolic the status and privileges of a floating lienor perfected by filing, as outlined in part I.A.¹⁷³

173. The present writer believes that the assumption of a prior floating lienor is a realistic one and that priority conflicts between secured creditors are relatively common. That view is shared by others, perhaps based on experience or anecdote. See, e.g., Lloyd, *supra* note 8, at 74 (purchase money priority is more necessary than ever because taking a blanket security interest in all of the borrower's property is a standard practice in commercial lending); *In re Southern Vermont Supply*, 58 Bankr. 887, 892 (Bankr. D. Vt. 1986) (prior lienor with after-acquired property clause is usually present in the "normal commercial setting").

Professor Scott's relational model of secured financing, however, predicts that relational lenders will insist on exclusive financing rights, since the benefit of relational financing only accrues when a single creditor owns exclusive rights to the growth opportunity which is the subject of financing. Priority conflicts between such creditors (e.g., the general inventory and receivables financier and the floorplanner) should therefore be rare. Scott, *supra* note 20, at 936. Scott finds empirical support for his view in the exclusivity provisions of standard financing agreements, as well as in a survey of cases involving priority disputes (other than cases involving crops or consumer goods) reported between 1964 and 1985. According to Scott, less than 5% of those cases involve priority conflicts between relational lenders. *Id.* at 949. While Scott is appropriately cautious in drawing conclusions due to the usual brevity of description of a secured creditor's role in most judicial opinions, he concludes that relational financiers appear to insist on exclusive control. *Id.* at 950.

Of course, if priority conflicts between "relational" financiers, such as floor planning lenders and general receivables and inventory financiers, account for anything close to 5% of reported cases, the rules governing such conflicts deserve careful analysis. Moreover, if one accepts the view that professional lenders are averse to litigation, one should expect priority disputes between professional lenders to be settled without appearing in the reporters. Finally, a number of trends reported in business- and practitioner-oriented literature would seem to support an inference that the floating lienor/inventory financier priority conflict in particular or, more generally, priority disputes between secured lenders due to the operation of future advance and after-acquired property clauses, will be even more common in the future.

First, the tendency for the first creditor in line to take a very broad lien on the debtor's assets is increasing. See Fagel, *Rights On Inventory*, 88 CREDIT AND FINANCIAL MANAGEMENT No. 1, 27 (1986) (working capital lenders with "rare exceptions" use after-acquired property clauses). Even where a bank has previously extended unsecured credit to a borrower, it may respond to a borrower's financial difficulty by collateralizing the loan under a new agreement. See Goldman, *Loans that Save Troubled Companies*, 72 NATION'S BUSINESS August 1984 at 49. Indeed, blanket liens are sufficiently common that there has been a serious proposal to dispense with the requirement that collateral be described by type in security agreements and financing statements. See Shanker, *A Proposal for a Simplified All-Embracing Security Interest*, 14 U.C.C. L.J. 23 (1981) (description requirement superfluous in light of the desire of most lenders to take a broad lien and the ease with which it can be accomplished). In addition, leveraged buyouts are frequently accomplished by borrowing against the assets of the target company, which emerges from the LBO subject to a blanket lien. See Miller, *MAS Consultant's Role in Asset-Based Financing*, 52 CPA JOURNAL April 1982 at 24, 26 (acquisition financing is "full house" financing). In all probability, only a portion of these broad lienors fit Scott's model of the exclusive relational financier of a firm

B. *Paradigm 1: No Cross-Collateralization (The Case of Formalist Finance)*

The first debtor subject to Bucolic's floating lien is a wholesale seller of big ticket appliances, Moe's Miracle Machine Co. ("Moe"). When Moe is unable to obtain further credit from Bucolic, it enters into an inventory financing arrangement with Formalist Finance Co. ("Formalist"). Initially, Formalist files a financing statement describing its collateral as "inventory" and gives notice to any other inventory lenders in a form sufficient to satisfy U.C.C. section 9-312(3).

Formalist makes advances from time to time to enable Moe to acquire inventory from various appliance manufacturers. Each advance takes the form of

specific growth opportunity. Further, it is doubtful that all borrowers subject to such broad liens will be content to continue financing through only one lender.

Second, inventory is increasingly used as "backstop" collateral by accounts receivable financiers, thus generating potential conflict with inventory lenders. See P. WEIL, *ASSET-BASED LENDING, AN INTRODUCTORY GUIDE TO SECURED FINANCING*, 235 (1989). Iannuccilli, *Asset Based Lending: An Overview*, J. COMM. BANK LENDING March 1988, 54 (describing "typical asset-based financing package"); Sannella, *Asset Based Financing*, JOURNAL OF ACCOUNTANCY, May 1983, at 44, 47; Tonus, *Asset-Based Financing: What CPA's Should Know*, JOURNAL OF ACCOUNTANCY, Sept. 1981, at 43-44.

Moreover, in retail trades in which floorplan financing is common, it is also common to find a single dealer financed by several floorplan lenders, each of which claims a broad lien on all inventory. See Goldman, *How to Avoid Problems in Floorplan Financing*, 31 PRACTICAL LAWYER No. 4 at 51, 53, 55 (1985). These developments increase the likelihood of priority conflicts between secured lenders (whether fully "relational" in Scott's sense or not). Such conflicts already occur with some regularity. See, e.g., *Southtrust Bank v. Borg-Warner Acceptance Corp.*, 760 F.2d 1240 (11th Cir. 1985); *Lettinga v. Agristor Credit Corp.*, 686 F.2d 442 (6th Cir. 1982); *Ingram v. Ozark Prod. Credit Ass'n*, 468 F.2d 564, 11 U.C.C. Rep. Serv. 605 (5th Cir. 1972); *In re Dupont Feedmill Corp.*, 121 Bankr. 555 (S.D. Ind. 1990); *Boatmen's Bank of Cape Girardeau v. Evans*, 715 F.Supp. 942 (E.D. Mo. 1988); *United States v. Ballard*, 645 F.Supp. 788 (D. Mont. 1986); *In re Daniels*, 35 Bankr. 247 (Bankr. W.D. Okla. 1983); *In re LaSelle's Bicycle World*, 120 Bankr. 579 (Bankr. N.D. Okla. 1990); *Ford Motor Credit Co. v. Beneficial Commercial Corp.* (*In re McClure*), 108 Bankr. 468 (Bankr. M.D. Pa. 1989); *In re Sunrise R.V. Inc.*, 107 Bankr. 277 (Bankr. E.D. Cal. 1989); *In re Ivie & Assocs., Inc.*, 84 Bankr. 882 (Bankr. N.D. Ga. 1988); *In re Henning*, 69 Bankr. 348 (Bankr. N.D. Ill. 1987); *In the Matter of Hooks*, 40 Bankr. 715 (Bankr. M.D. Ga. 1984); *In the Matter of Pinellas-Pasco Wholesale Tire Co., Inc.*, 36 Bankr. 559 (Bankr. M.D. Fla. 1983); *Kawasho Int'l (U.S.A.), Inc. v. Alper* (*In re Mid-Atlantic Flange Co., Inc.*), 26 U.C.C. Rep. Serv. 203 (E.D. Pa. 1979); *First Bank Billings v. Feterl Mfg. Co.* (*In re Parker Montana Co.*), 47 Bankr. 419 (D. Mont. 1985); *Ever Ready Machinists, Inc. v. Relpak Corp.* (*In re Relpak Corp.*), 25 Bankr. 148 (Bankr. E.D. N.Y. 1982); *Boatman's Bank of Pulaski County v. Smith* (*In re Smith*), 29 Bankr. 690 (Bankr. W.D. Mo. 1983); *In re Southern Vermont Supply, Inc.*, 58 Bankr. 887 (Bankr. D. Vt. 1986); *Marine Midland Bank v. United States*, 687 F.2d 395 (Ct. Cl. 1982); *Valley Bank v. Estate of Rainsdon*, 793 P.2d 1257 (Idaho App. 1990); *Borg-Warner Acceptance Corp. v. Tascosa Nat'l Bank*, 784 S.W.2d 129 (Tex. App. 1990); *Womack v. Newman Fixture Co.*, 27 Ark. App. 117, 785 S.W.2d 226 (1990); *NBD-Sandusky Bank v. Ritter*, 179 Mich. App. 580, 446 N.W.2d 340 (1989); *ITT Commercial Finance Corp. v. Union Bank & Trust Co. of North Vernon*, 528 N.E.2d 1149, 7 U.C.C. Rep. Serv. 2d 901 (Ind. App. 1988); *First Nat'l Bank in Brookings v. John Deere Co.*, 409 N.W.2d 664, 4 U.C.C. Rep. Serv. 2d 1168 (S.D. 1987); *Erlandson Implement, Inc. v. First State Bank of Brownsdale*, 400 N.W.2d 421, 3 U.C.C. Rep. Serv. 2d 349 (Minn. App. 1987); *DeKalb Bank v. Klotz*, 151 Ill. App. 3d 638, 502 N.E.2d 1256 (Ill. App. 1986); *Deutz-Allis Credit Corp. v. Lynch Farms, Inc.*, 387 N.W.2d 593, 1 U.C.C. Rep. Serv. 2d 1752 (Iowa 1986); *First Nat'l Bank of Vandalia v. Trail Ridge Farm, Inc.*, 143 Ill. App. 3d 244, 492 N.E.2d 1030 (1986); *Credit Alliance Corp. v. Amhoist Credit Corp.*, 74 Or. App. 257, 702 P.2d 1121 (1985); *Borg-Warner Acceptance Corp. v. ITT Diversified Credit Corp.*, 344 N.W.2d 841, 38 U.C.C. Rep. Serv. 1 (Minn. 1984); *Ford Motor Credit Co. v. First State Bank of Smithville*, 674 S.W.2d 437 (Tex. App. 1984), *rev'd* 679 S.W.2d 486 (Tex. 1984); *Thet Mah & Assocs. v. First Bank of North Dakota (NA)*, Minot, 336 N.W.2d 134, 36 U.C.C. Rep. Serv. 649 (N.D. 1983); *Coachmen Indus. Inc. v. Security Trust & Savings Bank of Shenandoah*, 329 N.W.2d 648, 35 U.C.C. Rep. Serv. 1012 (Iowa 1983); *Roemer and Zeller, Inc. v. Ace Transmission Center, Inc.*, 114 Misc. 2d 310, 451 N.Y.S.2d 601 (N.Y. Sup. Ct. 1982); *Peoples Bank & Trust Co. v. Comfort Engineering Co., Inc.*, 408 So.2d 1190 (Miss. 1982); *Steege Auto Parts Corp. v. Markey*, 2 Ohio App. 3d 200, 441 N.E.2d 279 (1981); *King's Appliance & Electronics, Inc. v. Citizen's & Southern Bank of Dublin*, 157 Ga. App. 857, 278 S.E.2d 733 (1981); *Tuftco Sales Corp. v. Garrison Carpet Mills*, 158 Ga. App. 674, 282 S.E.2d 159 (1981).

a check in the amount of the purchase payable jointly to Moe and the manufacturer supplying the inventory to Moe. At the time of each advance (but before delivery of the inventory), Formalist requires Moe to execute a standard form security agreement granting Formalist a purchase money security interest in the inventory purchased with the advance. An invoice from the manufacturer, showing the serial numbers of the appliances purchased, is attached to each such security agreement as part of the description of the collateral. Formalist keeps separate accounting records for each advance. Each time Moe sells an appliance, he is required to pay an amount corresponding to its cost¹⁷⁴ to Formalist, and Formalist applies each such payment to the outstanding balance on the advance with which it was purchased. Formalist likewise has discretion to require further payments if the total indebtedness under all security agreements reaches a specified level, upon certain specified events of default or insecurity, or at specified time intervals.

Formalist's records for each security agreement reflect the serial numbers of all appliances remaining unsold, and Moe is required by the security agreement to maintain similar records. Formalist also sends "floor checkers" to Moe's place of business from time to time in order to ensure that all collateral for which Formalist has not received payment remains on the premises and segregated from inventory acquired from other sources. In the event of a default or insolvency, Formalist will claim a purchase money security interest in all remaining appliances purchased with Formalist advances.¹⁷⁵

C. *Paradigm 2: Limited Cross-Collateralization (the Case of Felicitous Finance)*

The second debtor subject to Bucolic's floating lien is a retail purveyor of that most fungible of all possible goods, the widget. Larry's Widgets, Inc. ("Larry") buys widgets from a number of different manufacturers and resells them to industrial widget users. When Bucolic refuses to finance new inventory acquisitions, Larry turns to Felicitous Finance Co. ("Felicitous") for credit.

Instead of using a series of security agreements, however, Felicitous enters into a single security agreement with Larry. The security agreement defines the "obligations" secured as any and all advances or extensions of credit used to purchase inventory for Larry. It defines "collateral" as widget inventory, provided the inventory is purchased with advances or extensions of credit by Felicitous. Appropriately drafted future advance and after-acquired property clauses then make it clear that all obligations (in the foregoing restricted sense) are secured by all collateral (again, in the defined sense), regardless of date of ac-

174. The amount required to be remitted could also include an interest or finance charge, or such charges could be billed separately at regular intervals. As the mechanism for interest payments does not affect the analysis, it will be ignored. Obviously, most of the routine matters covered in security agreements will likewise be ignored.

175. The Formalist financing arrangement is reminiscent of the self-liquidating character of traditional trust receipt financing, except that separate security agreements are issued at each extension of credit instead of trust receipts. See 1 G. GILMORE, *supra* note 17, § 4.12 at 124-25. U.C.C. § 9-102(2) authorizes the continuation of traditional security devices (albeit under Article 9 rules), and trust receipt financing has not disappeared. See, e.g., *In re Southern Vermont Supply, Inc.*, 58 Bankr. 887 (Bankr. D. Vt. 1986).

quisition.¹⁷⁶ Felicitous has thus attempted a limited form of cross-collateralization. Its lien "floats" over a pool of collateral, but the collateral is all purchase money collateral. Its lien secures a consolidated debt, all components of which are purchase money advances.¹⁷⁷

Under the security agreement, one-third of each advance¹⁷⁸ is due thirty days from the date it is made, with an additional third due at sixty and at ninety days.¹⁷⁹ Debt falling due at the same time from different advances is consolidated. Payments by Larry are applied to the outstanding consolidated balance.¹⁸⁰ Felicitous does require Larry to segregate the inventory it finances from inventory purchased with funds from other sources, and on-site inspections are made at Larry's place of business. However, no attempt is made by Larry or Felicitous to determine which of the series of advances was used to purchase collateral on hand at any given time. In the event of default or insolvency, Felicitous claims a purchase money security interest in all remaining widgets (whenever acquired) purchased with Felicitous funds.¹⁸¹

D. *Paradigm 3: Full Cross-Collateralization (The Case of Felonious Finance)*

The third debtor subject to Bucolic's floating lien is Curly's Computers ("Curly"), a retail computer and home electronics dealer. When Curly is unable to obtain further credit from Bucolic, it seeks and obtains inventory financing from Felonious Finance Co. ("Felonious").

Felonious is primarily interested in financing Curly's acquisition of computers on a purchase money basis. However, the parties leave open the possibility of an expanded financing arrangement including some nonpurchase money advances secured by accounts receivable. Accordingly, the security agreement

176. It is assumed that Felicitous has given the notice required by U.C.C. § 9-312(3) and filed a financing statement.

177. Arrangements such as the Felicitous financing arrangement will be characterized as "limited cross-collateralization" in this Article. Limited cross-collateralization thus differs from full cross-collateralization in that the latter is indifferent to the purpose and use of the advances creating the debt and the source of payment for the collateral.

178. As in the case of the Formalist arrangement, advances take the form of checks payable jointly to Larry and his supplier.

179. As in the case of Paradigm 1, provisions for interest payments and other matters covered in most security agreements will be ignored.

180. Thus, if Larry makes only a partial payment there is no way to tell which advance the due and outstanding balance "came from." As an alternative to the billing and payment arrangement described in the text, all advances on Larry's behalf might be consolidated immediately, and Larry might be required to pay a specified percentage of the outstanding balance (perhaps graduated according to the size of the balance) each month. Under the alternative procedure, there is a single debt, not differentiated into its component advances, from the outset.

181. The Larry/Felicitous agreement is based on *Southtrust Bank v. Borg-Warner Acceptance Corp.*, 760 F.2d 1240 (11th Cir. 1985). In that case, the purported purchase money creditor claimed to be operating under an arrangement similar to that used in the hypothetical, although its documents were not entirely consistent with the hypothetical case. Specifically, although Borg-Warner Acceptance Corp. did define "collateral" in a way which confined that term to inventory it had financed, it did not confine the term "obligations" in a parallel fashion to debt arising from purchase money advances. See *Southtrust*, 760 F.2d at 1241-42. There is no indication, however, that any advances other than purchase money advances were made. The Larry/Felicitous agreement is also analogous to the cross-collateralization provisions expressly permitted in consumer credit sales by § 3.302(1) of the Uniform Consumer Credit Code ("UCCC"). It differs from the cross-collateralization permitted by the U.C.C. in not incorporating a first in, first out payment allocation principle, as codified in § 3.303(1).

executed by the parties does not confine the definition of the obligations secured to purchase money advances. The agreement does explicitly grant Felonious a purchase money security interest in Curly's inventory, but it also grants a general security interest in all "collateral," and the term "collateral" is defined so that it also includes Curly's equipment, nonpurchase money inventory, and accounts receivable. Appropriate future advance and after-acquired property clauses make it clear that all "obligations" are secured by all "collateral." On its face, therefore, the Felonious/Curly arrangement provides for full cross-collateralization.

Felonious is not required to (and does not) keep separate accounting records for its various advances, and payments are simply applied to a single running balance. Curly is required to remit to Felonious a specified percentage of amounts received from the sale of inventory,¹⁸² and Felonious has the power to require further payments in the event the total outstanding balance exceeds a specified ratio to inventory (or other collateral) on hand. Felonious periodically inspects Curly's inventory and requires the physical segregation of inventory purchased with Felonious funds.¹⁸³

VARIANT A: Felonious, in fact, makes nothing but purchase money advances to Curly, all of which take the form of checks payable jointly to Curly and the relevant inventory supplier.

VARIANT B: Felonious, in fact, makes several purchase money inventory advances to Curly. The total of such advances amounts to 100,000 dollars. Felonious also, however, makes one 20,000 dollar advance against Curly's receivables, one 10,000 dollar advance against its existing business equipment, and one 10,000 dollar advance to enable Curly to purchase a forklift for its warehouse.

E. *The Comparative Advantages of the Paradigms*

Depending on the nature of the debtor's business, there are competing reasons to prefer one or the other of the foregoing financing arrangements. Paradigm 1 offers the lender the maximum protection against becoming undersecured, and it may likewise offer the debtor whose resale demand is seasonal the advantage of not requiring large repayments of principal until inventory is actually sold. On the other hand, a debtor who felt confident he could turn his inventory within ninety days might have reason to prefer Paradigm 2. To the extent he can sell inventory faster than his repayment schedule requires him to remit proceeds, he has the benefit of the use of money to a greater extent than permitted by Paradigm 1. While this creates a greater risk of undersecured status for the lender, Paradigm 2 offers the compensating advantage of a more

182. Once again, the example is indifferent to the method of interest payments and other routine provisions of security agreements.

183. Paradigm 3 thus appears by its terms to be a partial floating lien - *i.e.* it stops short of encumbering all of Curly's assets. It is similar to forms of documentation for inventory loans recommended by some commentators and some asset-based lending guides. See Aronov, *supra* note 114, at 47; Weil, *supra* note 173, at 237, 257. For a case in which two secured creditors used broad collateral descriptions in financing statements but, in fact, appear to have engaged primarily in purchase money inventory financing, see *In re Sunrise R.V. Inc.*, 107 Bankr. 277 (Bankr. E.D. Cal. 1989).

predictable (and, in some cases, more rapid) repayment schedule. It also requires somewhat less complicated accounting and much less monitoring of the debtor and the collateral than Paradigm 1, and is therefore cheaper to administer. Paradigm 3 may be preferred by a debtor and lender who contemplate both purchase money inventory financing and financing for other purposes, and, while the general security interest in nonpurchase money collateral may be subordinate to that of a prior floating lienor, it may not be valueless in all cases.

Thus, apart from legal considerations, all three paradigms seem to admit the possibility of some business justification. Nevertheless, it is absolutely clear that current case law renders Paradigms 2 and 3 risky in the extreme.

III. CROSS-COLLATERALIZATION AND PURCHASE MONEY STATUS

A. *The Major Stumbling Block*

The case creating the greatest single obstacle to cross-collateralization by purchase money inventory financiers is *Southtrust Bank v. Borg-Warner Acceptance Corp.*¹⁸⁴ That case was a priority contest between a purported purchase money inventory financier—Borg-Warner Acceptance Corp. (“BWAC”)—and a bank (Southtrust Bank) with a floating security interest in inventory perfected by a prior filing.¹⁸⁵ BWAC claimed priority over the prior filer on the basis of the Code’s purchase money provisions.¹⁸⁶

The agreements between BWAC and the four debtors involved in the case each expressly granted BWAC a security interest in the relevant debtor’s inventory, and each defined “inventory” as inventory financed by BWAC.¹⁸⁷ While the court’s opinion is not entirely clear on the point, it appears that the only advances BWAC made to any of the debtors were advances used for the purpose of purchasing inventory.¹⁸⁸ Each agreement contained a future advance clause and an after-acquired property clause, so that all collateral secured all obligations.¹⁸⁹ The repayment provisions were characterized as a “scheduled liquidation arrangement,” under which BWAC was repaid a portion of its advance each month, regardless of whether the inventory was sold.¹⁹⁰ The behavior of the parties thus appears to be an instance of the kind of limited cross-collateralization found in the Larry/Felicitous agreement of Paradigm 2. The BWAC agreement, however, did not confine the term “obligations” to purchase money advances; thus, even though no other advances were made, the agreement did purport to collateralize any kind of debt with all BWAC-financed inventory.¹⁹¹ The documentation, therefore, appears to be partly analogous to Paradigm 2 (in confining collateral to purchase money collateral) and partly analogous to Paradigm 3 (in not expressly confining debt to purchase money debt). The bank

184. 760 F.2d 1240 (11th Cir. 1985).

185. *Id.* at 1241.

186. *Id.*

187. *Id.* at 1242.

188. *Id.* at 1241, 1243.

189. *Id.* at 1241-42.

190. *Id.* at 1242.

191. *Id.*

contended that the mere presence in the BWAC security agreement of future advance and after-acquired property clauses destroyed any claim to purchase money status, and that the bank's prior filing gave it priority under section 9-312(5) of the Code.¹⁹²

The Court of Appeals for the Eleventh Circuit held in favor of the bank. Its *per curiam* opinion is cryptic and confusing. Initially,¹⁹³ the court expressed its approval of three individual bankruptcy cases, *In re Manuel*,¹⁹⁴ *In re Norrell*,¹⁹⁵ and *In re Simpson*,¹⁹⁶ in which the "transformation rule" (*i.e.*, the rule that a purported purchase money security interest is "transformed" into an ordinary security interest by the presence of the offending future advance and after-acquired property clauses) was applied. In so doing, the court implicitly invoked a battery of stock arguments (to be discussed in detail *infra* in Part III), none of which it explained adequately. The court explicitly referred only to the *Manuel* court's pronouncement that a purchase money security interest cannot exceed the "price of what is purchased."¹⁹⁷

The court then rejected BWAC's argument that the transformation rule should be confined to the context of consumer bankruptcies. The court justified its rejection solely by the absence of any explicit basis for distinguishing commercial and consumer transactions, or bankruptcy and nonbankruptcy cases, in U.C.C. section 9-312(3) or U.C.C. section 9-107.¹⁹⁸

The court next disposed of BWAC's argument that the transformation rule should not be applied where a future advance clause and after-acquired property clause had not been "exercised."¹⁹⁹ The court found an "exercise" of the future advance clause in BWAC's claim that multiple advances were all secured by the collateral pool, and it found an exercise of the after-acquired property clause in the contention that inventory purchased subsequent to the original security agreement was purchase money collateral.²⁰⁰ For practical purposes, therefore, such clauses are "exercised" whenever the creditor under a cross-collateralization arrangement makes more than one advance and seeks to take advantage of the express cross-collateralization provisions of his agreement, as BWAC had. The court concluded that "a floating lien is inconsistent with a PMSI," and that "[a] PMSI requires a one-to-one relationship between the debt and the collateral."²⁰¹ Thus, apparently only arrangements like the Moe/

192. *Id.* BWAC faced a similar argument more recently, but repelled it with greater success, in *Borg-Warner Acceptance Corp. v. Taxcosa Nat'l Bank*, 784 S.W.2d 129 (Tex. App. 1990).

193. *Id.*

194. 507 F.2d 990 (5th Cir. 1975).

195. 426 F. Supp. 435 (M.D. Ga. 1977).

196. 4 U.C.C. Rep. Serv. (Callaghan) 243 (Bankr. W.D. Mich. 1966).

197. *Southtrust*, 760 F.2d at 1242, quoting *In Re Manuel*, 507 F.2d at 993. In *In re Ionosphere Clubs, Inc.*, 112 Bankr. 78 (Bankr. S.D. N.Y. 1990), the court applied the rules, and much of the rationale, of *Manuel* and *Southtrust* in the context of major commercial equipment financing.

198. *Southtrust*, 760 F.2d at 1242.

199. *Id.*, at 1243.

200. *Id.*

201. *Id.* But see *Borg-Warner Acceptance Corp. v. Taxcosa Nat'l Bank*, 784 S.W.2d 129, 134 (Tex. App. 1990) (suggesting that the use of the term "inventory" is incompatible with such an item-by-item analysis).

Formalist agreement found in Paradigm 1 pass muster.²⁰² Under the court's analysis, neither Felicitous of Paradigm 2 nor Felonious of Paradigm 3 could claim purchase money status, since both rely on future advance and after-acquired property clauses.

The *Southtrust* case has been alternately magnified and vilified by various commentators.²⁰³ More importantly, because it presents the issue of the compatibility of purchase money status and cross-collateralization so directly, it now casts a shadow over apparently useful forms of financing such as Paradigm 2 and Variant A of Paradigm 3.²⁰⁴ In a sense, its prominence is ironic, for so little is explained in the opinion and so much is implied or invoked by a simple citation of authority. Accordingly, it is necessary to unravel and amplify the various strands of *Southtrust* and explore their validity. In the process, it will be established that the objections to limited cross-collateralization arrangements are specious and that such arrangements are consistent with the language and policy of the Code.

B. "Purchase Money Collateral May Not Secure More Than Its Price"

1. The Basic Argument

The first argument purportedly establishing the incompatibility of purchase money status and cross-collateralization, and the primary basis of *Southtrust*, is an interpretation of the text of U.C.C. section 9-107, which provides:

202. The *Southtrust* court held out one ray of hope for creditors seeking to combine purchase money status and even a limited degree of cross-collateralization. The court suggested that such an arrangement could be saved if the parties, by express contractual arrangement, provided a payment allocation formula sufficient to determine "the extent to which each item of collateral secures its purchase money." As the BWAC agreement had no such provision, however, BWAC's security interest failed to qualify as a purchase money security interest, and BWAC's security interest was therefore subordinate to that of the bank. *Southtrust*, 760 F.2d at 1243.

203. Compare B. CLARK, *supra* note 70, ¶ 3.09[3][a] at 3-99 (*Southtrust* "seems correct"); Hansford, *The Purchase Money Security Interest in Inventory Versus the After-Acquired Property Interest—A "No Win" Situation*, 20 U. RICH. L. REV. 235, 262 (1986) (*Southtrust* reached proper result, even though basis for it is flawed); with Beard, *The Purchase Money Security Interest in Inventory: If it Does Not Float, it Must Be Dead*, 57 TENN. L. REV. 437, 444 (1990) (*Southtrust* is wholly inconsistent with the purpose, policy, and history of the Code); Marshall, *Commercial Law (Annual Survey of Georgia Law)*, 37 MERCER L. REV. 139, 155 (1985) (*Southtrust* decision "burdens inventory financing while furthering no apparent policy goals"); Aronov, *supra* note 114 at 45 (cases like *Southtrust* "are totally unjustified"); Smith, *Secured Transactions*, 41 BUS. LAW. 1463, 1484-86 (criticizing *Southtrust* on a number of grounds). See also, Lloyd, *supra* note 8 at 91 (suggesting *Southtrust* is a trap for the unwary).

204. Most recently, the shadow of *Southtrust* fell upon the Eastern Air Lines bankruptcy litigation. In *In re Ionosphere Clubs, Inc.*, 112 Bankr. 78 (Bankr. S.D. N.Y. 1990), Eastern Air Lines, as debtor in possession in its proceeding under Chapter 11 of the Bankruptcy Code, sought a declaration that the security interest held by a group of foreign banks (collectively called the "Airbus Lenders") was not a purchase money equipment security interest ("PMESI") and so not eligible for the special protection afforded a PMESI in aircraft and aircraft parts by 11 U.S.C. § 1110, 112 Bankr. at 80-81. At the time of the Chapter 11 Petition, the outstanding principal on the notes representing the secured obligation was \$95.8 million (*Id.* at 80). The notes reflected advances by the Airbus Lenders to enable Eastern to purchase aircraft and parts, and the notes were purportedly secured by a floating collateral pool. *Id.* at 80, 82. The court initially decided to construe the meaning of "purchase money equipment security interest" under § 1110 of the Bankruptcy Code by analogy to U.C.C. § 9-107, 112 Bankr. at 82). Then, relying in part on *Southtrust*, the court concluded that the floating collateral pool arrangement precluded the Airbus Lenders from asserting a PMESI. While the financing arrangement in *Ionosphere* was, indeed, suspect as a matter of U.C.C. law, the court's reliance on *Southtrust* distracted the court with irrelevant issues and kept it from focusing on the truly objectionable features of the financing arrangements. See *infra* note 304.

A security interest is a "purchase money security interest" to the extent that it is (a) taken or retained by the seller of the collateral to secure all or part of its price; or (b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

Put briefly, the argument is that the "its price" language of U.C.C. section 9-107(a) precludes any form of cross-collateralization. Cross-collateralization makes each item of collateral secure not only its own price, but the price of all other collateral, and, by definition, purchase money collateral may secure *only* "its price."

2. The Consumer "Add-On" Cases

a. The Transformation Rule

The argument did not originate with *Southtrust*, and assessment of inventory financing arrangements is not even its primary use. One recurring situation in which the "its price" argument is made is in the context of an attack by a consumer on an "add on" provision²⁰⁵ in a consumer financing agreement.²⁰⁶ *In re Manuel*²⁰⁷ and *In re Norrell*,²⁰⁸ upon which the *Southtrust* court relied,²⁰⁹ are both typical instances of this pattern. In each case, a consumer made successive credit purchases of consumer goods from a single retailer.²¹⁰ In each case, the seller reserved a security interest in the goods sold, and in each case the effect of the governing documents was the continuation of a security interest in all such goods until the entire combined indebtedness was paid.²¹¹ Thus the agreements in question appear to be the functional equivalent, in the consumer context, of the Felicitous/Larry limited cross-collateralization agreement found in Paradigm 2. All debt resulted from credit enabling the debtor to acquire the goods; all collateral consisted of goods acquired by virtue of the seller's exten-

205. In this Article, the term "add on provision" refers to a provision (or provisions) in an agreement (or series of agreements) for the sale or financing of consumer goods which purports to cross-collateralize (or has the effect of cross-collateralizing) a debtor's series of purchases from the same vendor. Add-on provisions thus produce limited cross-collateralization.

206. See generally *Pristas v. Landaus of Plymouth, Inc. (In re Pristas)*, 742 F.2d 797 (3rd Cir. 1984); *Roberts Furniture Co. v. Pierce (In re Manuel)*, 507 F.2d 990 (5th Cir. 1975); *Skinner's Furniture Store of Greenville, Inc. v. McCall (In re McCall)*, 62 Bankr. 57 (M.D. Ala. 1985); *Goodyear Tire & Rubber Co. v. Staley, (In re Staley)*, 426 F. Supp. 437 (M.D. Ga. 1977); *W.S. Badcock Corp. v. Banks (In re Norrell)*, 426 F. Supp. 435 (M.D. Ga. 1977); *Bond's Jewelers, Inc. v. Linklater (In re Linklater)*, 48 Bankr. 916 (Bankr. D. Nev. 1985); *In re Nolen*, 53 Bankr. 235 (Bankr. M.D. Tenn. 1985); *Breakiron v. Montgomery Ward (In re Breakiron)*, 32 Bankr. 400 (Bankr. W.D. Pa. 1983); *Keller v. Household Fin. Corp. Retail Servs., Inc. (In re Keller)*, 29 Bankr. 91 (Bankr. M.D. Fla. 1983); *In re Sprague*, 29 Bankr. 711 (Bankr. M.D. Pa. 1983); *In re Wilson*, 25 Bankr. 276 (Bankr. D. Neb. 1982); *Ashworth v. McMahan's Furniture (In re Ashworth)*, 16 Bankr. 645 (Bankr. C.D. Cal. 1981); *Butterworth Furniture Co. v. Penny (In re Penny)*, 15 Bankr. 124 (Bankr. E.D. Va. 1981); *Landaus of Plymouth, Inc. v. Scott (In re Scott)*, 5 Bankr. 37 (Bankr. M.D. Pa. 1980); *In re Brouse*, 6 UCC Rep. Serv. (Callaghan) 471 (Bankr. W.D. Mich. 1969).

207. *In re Manuel*, 507 F.2d 990.

208. *In re Norrell*, 426 F. Supp. 435.

209. *Southtrust*, 760 F.2d at 1242.

210. *In re Manuel*, 507 F.2d at 991; *In re Norrell*, 426 F. Supp. at 435-36.

211. *In re Manuel*, 507 F.2d at 992; *In re Norrell*, 426 F. Supp. at 436.

sion of credit. The seller's lien, however, "floated" only over the limited pool of purchase money collateral.

The court in *Manuel* found the future advance aspect²¹² of the limited cross-collateralization arrangement fatal to purchase money status. The court focused on the language of U.C.C. section 9-107(a) defining a purchase money security interest as one taken to secure "its price."²¹³ The court reasoned that, when the goods purchased in the initial sale continued to serve as collateral after the second sale was made, the original set of goods secured not only its own price, but the price of the goods acquired in the second sale.²¹⁴ Once the original purchase money collateral secured more than "its price," the arrangement violated U.C.C. section 9-107(a), which, in turn, resulted in a loss of purchase money character of the security interest, at least as to the first batch of goods purchased.²¹⁵ Unfortunately, the creditor had chosen not to perfect by filing but rather to rely on the automatic perfection accorded a purchase money security interest in consumer goods.²¹⁶ Loss of purchase money status therefore resulted in loss of perfection, and, in consequence, the security interest was subordinate to the interest of the Trustee in Bankruptcy.²¹⁷ The *Norrell* court followed *Manuel* in conclusion and reasoning.²¹⁸ Indeed, there are other consumer "add on" cases in which the argument based on the "its price" language of U.C.C. section 9-107(a) was applied to limited cross-collateralization arrangements and the result was to deprive the creditor of his purchase money status entirely.²¹⁹

b. *The Dual Status Rule*

In other cases of the same kind, however, the results were not quite so harsh.²²⁰ *Pristas v. Landaus of Plymouth, Inc.*²²¹ is illustrative of the more leni-

212. The issue of whether the *last* item purchased by the debtor was the subject of a PMSI had not been preserved for appeal. See *In re Manuel*, 507 F.2d at 992, 994. Accordingly, the only question presented was whether the fact that the goods *first* purchased secured debt created by a *later* purchase removed the security interest from the category of a PMSI. The parallel issue, *i.e.*, whether the fact that the *last* goods purchased secured debt created by *previous* purchases would also result in a loss of purchase money status was not presented, but the reasoning of the *Manuel* opinion would clearly require the same result.

213. *In re Manuel*, 507 F.2d at 993 (emphasis in original).

214. See *Id.*

215. *Id.*

216. *Id.*

217. *Id.* at 992.

218. See *W.S. Badcock Corp. v. Banks (In re Norrell)*, 426 F.Supp. at 435, 436.

219. See, *e.g.*, *Butterworth Furniture Co. v. Penny (In re Penny)*, 15 Bankr. 124, 127; *Landaus of Plymouth, Inc. v. Scott (In re Scott)*, 5 Bankr. 37, 39-40. See also *Southtrust Bank v. Borg-Warner Acceptance Corp.*, 760 F.2d 1240 (11th Cir. 1985) (applying the "its price" argument in the context of commercial inventory financing) and *In re Ionosphere Clubs, Inc.*, 112 Bankr. 78 (Bankr. S.D. N.Y.) (applying the "its price" argument in the context of commercial equipment financing).

220. See, *e.g.*, *Pristas*, 742 F.2d at 801-02 (PMSI is retained to the extent it can be determined that each item of collateral continues to secure its own price, said determination to be made on the basis of a payment allocation provision of a state statute); *Greenville, Inc. v. McCall (In re McCall)*, 62 Bankr. at 59-60 (PMSI is retained to the extent each item of collateral secures its own price, as determined by application of contractual provisions for "first in, first out" ("FIFO") allocation of payment to debt); *Goodyear Tire & Rubber Co. v. Staley (In re Staley)*, 426 F. Supp. at 437-38 (allocation of payments provision in credit agreement assured that collateral would secure only its price); *In re Nolen*, 53 Bankr. at 236-37 (transformation rule rendered inapplicable by nonstandard Tennessee amendment to U.C.C. § 9-107 expressly permitting limited cross-collateralization and

ent approach. In *Pristas*, a consumer made two successive purchases of household goods from the same vendor under agreements which effectively consolidated the debt from the two purchases and made both items collateral for the entire outstanding balance.²²² The debtor filed a petition in bankruptcy and sought to avoid the creditor's security interest as a nonpossessory nonpurchase money lien within the ambit of the debtor's avoidance power under 11 U.S.C. section 522(f)(2).²²³ The debtor argued that purchase money status had been lost as soon as the original item of collateral secured more than "its price."²²⁴ The court acknowledged the "transformation rule" cases which rely on the "its price" language of U.C.C. section 9-107 and made no real attempt to dispute the fundamental incompatibility of purchase money status and limited cross-collateralization.²²⁵ Rather, the court merely qualified the transformation rule by holding that less severe consequences should follow when a creditor attempts to make collateral secure more than "its price." The court found its limiting principle in the preamble of U.C.C. section 9-107, (*i.e.*, the language that a security interest had purchase money status "to the extent" it satisfied the requirements of subsection (a)).²²⁶ The clause "to the extent" entails that a security interest may have "dual status"; it is a purchase money security interest "to the extent" it secures its price and a nonpurchase money, garden-variety security interest to the extent it secures other debt.²²⁷ Therefore, as long as there is some method for determining, in light of the debtor's payments, how much of the "price" of each item is paid and how much remains unpaid,²²⁸ the purchase money security interest is not completely avoidable.²²⁹ Rather, it survives to the extent an item of collateral secures "its price" and perishes at the hands of a bankrupt debtor armed with 11 U.S.C. section 522(f) to the extent it secures anything else. Finally, the court noted that, in addition to giving effect to the "to the extent language" of the preamble to U.C.C. section 9-107, the tolerance of add-on debt permitted by the dual status rule "carries out the approbation for purchase-money security arrangements,"²³⁰ simplifies repeat transactions be-

providing for FIFO payment allocation in the case of consumer goods); *Breakiron v. Montgomery Ward* (*In re Breakiron*), 32 Bankr. at 402-03 (PMSI sustained where state statute provided for pro rata payment allocation according to ratio of original cash sale prices); *Keller v. Household Finance Corp. Retail Services* (*In re Keller*), 29 Bankr. at 93 (PMSI sustained because security agreement provided for FIFO payment allocation); *In re Sprague*, 29 Bankr. at 713 (PMSI preserved where all debt and collateral are purchase money and equitable tracing rules can be applied); *Ashworth v. McMahan's Furniture* (*In re Ashworth*), 16 Bankr. at 647 (final in series of security agreements remains PMSI although prior security agreements lose purchase money status); *In re Brouse*, 6 U.C.C. Rep. Serv. at 475 (PMSI saved where state statute provides for pro rata payment allocation according to ratio of original cash sale prices).

221. 742 F.2d 797.

222. *Id.* at 798-99.

223. *Id.* at 799.

224. *Id.*

225. *Id.* at 800.

226. *Id.*

227. *Id.* at 801.

228. Ultimately, the court found the appropriate allocation principle in a Pennsylvania statute requiring pro rata payment allocation according to the ratio of original cash sale prices. *Id.* at 802.

229. *Id.* at 801. This possibility was of course expressly left open in *Southtrust* but the *Southtrust* court found the absence of a contractual allocation formula fatal. *See supra* note 202.

230. *Pristas*, 742 F.2d at 801.

tween the same buyer and seller, increases sales, and is no more detrimental to the buyer than a series of purchases from different vendors.²³¹

Although the transformation rule and the dual status rule were portrayed in *Pristas* as polar opposites, it is clear that the latter is a mere qualification of the former.²³² Both rules are based on the same fundamental assumption that purchase money debt and collateral can never really be consolidated and cross-collateralized. Even if the debt from two successive purchases is consolidated as a matter of accounting, it is assumed that the separate "prices" of each item survive and can be (indeed *must* be) correlated to separate items of collateral. This is true even if, as in the consumer add-on cases, each successive debt and each item of collateral would have purchase money status considered in isolation. The difference between the strict version of the transformation rule and the dual status rule is only in the harshness of the penalty imposed if the creditor tries to accomplish anything more complex than a series of discrete, unrelated, and successive purchase money transactions. Under the transformation rule, purchase money status is lost entirely. Under the dual status rule, the loss of purchase money status may be partial only if the creditor has a payment allocation method which enables him to isolate the remaining "price" of particular items of collateral. The dual status rule is thus merely a less punitive qualification of the transformation rule, not a rule built on a different foundation.

3. *The Refinancing Cases*

The other recurring situation in which the argument based upon the "its price" language of U.C.C. section 9-107(a) appears is the refinancing of secured debt. Usually, the question arises when an individual debtor who has been a party to such a refinancing files a petition in bankruptcy and seeks to avoid a security interest under 11 U.S.C. section 522(f)(2) as a "nonpossessory nonpurchase money security interest" in property which would otherwise be exempt from claims of creditors. Virtually all the cases involve a repetitive series of transactions between the debtor and a lender or seller and an ultimate refinancing which combines and consolidates all outstanding debt. In some cases, all the outstanding debt is debt incurred to acquire collateral and all collateral consists of goods acquired with the creditor's advances or extensions of credit.²³³ In

231. *Id.*

232. Professor Lloyd distinguishes between cases like *Goodyear Tire & Rubber Co. v. Staley*, (*In re Staley*), 426 F. Supp. 437 (M.D. Ga. 1977), a transformation rule case in which the function of the allocation provision is to prevent an item from securing more than "its price," and true dual-status cases, in which an item admittedly secures more than "its price" and the allocation provision allows the court to determine how much of "the price" remains unpaid. See Lloyd, *supra* note 8 at 65-66. See also *In re Ionosphere Clubs, Inc.*, 112 Bankr. 78 (S.D.N.Y. 1990) (alternative holdings that a) a PMSI was never created, or b) purchase money status was lost through cross-collateralization). Lloyd's distinction is well-taken, but the argument in the text is not affected by it.

233. See, e.g., *Gillie v. First State Bank of Morton, Texas* (*In re Gillie*), 96 Bankr. 689 (Bankr. N.D. Tex. 1989) (refinancing of single purchase money debt; PMSI lost); *Billings v. Avco Colorado Indus. Bank* (*In re Billings*), 838 F.2d 405 (10th Cir. 1988) (refinancing of single purchase money transaction; court adopts dual status rule); *Bond's Jewelers, Inc. v. Linklater* (*In re Linklater*), 48 Bankr. 916 (Bankr. D. Nev. 1985) (consolidation of 2 PMSIs; court applies dual status rule in light of contractual provision for FIFO payment allocation); *Skinner's Furniture Store of Greenville, Inc. v. McCall* (*In re McCall*), 62 Bankr. 57 (Bankr. M.D. Ala. 1985) (2 successive purchases under same security agreement; FIFO allocation provision saves PMSI under dual status

other cases, however, additional (nonpurchase money) collateral is added as security for the consolidated debt.²³⁴ Similarly, in some cases the creditor, on refi-

rule); *Gayhart v. Beneficial Fin. Co. of Ill.* (*In re Gayhart*), 33 Bankr. 699 (Bankr. N.D. Ill. 1983) (renewal of single purchase money debt; PMSI upheld); *Fickey v. Bank of Lafayette* (*In re Fickey*), 23 Bankr. 586 (Bankr. E.D. Tenn. 1982) (refinancing of single conditional sale contract with apparent addition of refinancing charge; PMSI lost in absence of payment allocation formula); *In re Georgia*, 22 Bankr. 31 (Bankr. S.D. Ohio 1982) (refinancing of single purchase money debt does not result in loss of PMSI; dictum suggests different result if additional debt had been added); *Schewel Furniture Co. v. Goard* (*In re Goard*), 26 Bankr. 316 (Bankr. M.D.N.C. 1982) (series of purchase money security agreements, each of which consolidated entire debt; PMSI retained where state statute provides pro rata repayment allocation principle); *In re Haus*, 18 Bankr. 413 (Bankr. D.S.C. 1982) (consolidation of successive purchase money transactions; PMSI lost in absence of payment allocation provision); *In re Hobdy*, 18 Bankr. 70 (Bankr. W.D. Ky. 1982) (consolidation of purchase money transactions; PMSI in last items of collateral preserved where no payments had been made and final contract allocated debt); *Credithrift of America v. Littlejohn* (*In re Littlejohn*), 20 Bankr. 695 (Bankr. W.D. Ky. 1982) (renewal of single PMSI does not imply loss of purchase money status); *In re Mattson*, 20 Bankr. 382 (Bankr. W.D. Wis. 1982) (consolidation of PMSIs; PMSIs preserved by payment allocation provision); *Ashworth v. McMahan's Furniture* (*In re Ashworth*), 16 Bankr. 645 (Bankr. C.D. Cal. 1981) (series of five purchase money security agreements, each of which refinances and cross-collateralizes entire debt; PMSI lost except as to goods covered by last contract); *Butterworth Furniture Co. v. Penny* (*In re Penny*), 15 Bankr. 124 (Bankr. E.D. Va. 1981) (PMSI lost); *Coronado v. Beach Furniture and Appliance, Inc.* (*In re Coronado*), 7 Bankr. 53 (Bankr. D. Ariz. 1980) (consolidation of two purchase money debts; PMSI lost in absence of payment allocation provision allowing progressive release of collateral); *In re Krulik*, 6 Bankr. 443 (Bankr. M.D. Tenn. 1980) (consolidation of several purchase money debts; PMSI lost in absence of allocation provision); *Mulcahy v. Indianapolis Morris Plan Corp.* (*In re Mulcahy*), 3 Bankr. 454 (Bankr. S.D. Ind. 1980) (consolidation of two purchase money debts; PMSI in first collateral lost); *Landaus of Plymouth v. Scott* (*In re Scott*), 5 Bankr. 37 (Bankr. M.D. Pa. 1980) (consolidation of several purchase money agreements; PMSI lost).

234. See, e.g., *Matthews v. TransAmerica Fin. Servs.* (*In re Matthews*), 724 F.2d 798, 800 n.3 (9th Cir. 1984) (court declines to reach argument that collateral may not secure more than "its price" but suggests, in dictum, that it is against weight of authority; PMSI created even though nonpurchase money collateral included from inception, but PMSI lost on refinancing); *In re Snipes*, 86 Bankr. 1006 (Bankr. W.D. Mo. 1988) (purchase money debt consolidated with new loan and additional collateral taken; PMSI lost under transformation rule); *In re Harrell*, 72 Bankr. 107 (Bankr. N.D. Ala. 1987) (purchase money debt consolidated with other debt and nonpurchase money collateral added; PMSI lost); *Russell v. Associates Fin. Servs. of Okla., Inc.* (*In re Russell*), 29 Bankr. 270 (Bankr. W.D. Okla. 1983) (refinancing included cash advance and addition of nonpurchase money collateral; court adopts dual status rule and determines extent of PMSI using FIFO allocation principle); *Associates Fin. v. Conn* (*In re Conn*), 16 Bankr. 454 (Bankr. W.D. Ky. 1982) (refinancing includes new cash advance and addition of nonpurchase money collateral; court applies dual status rule and determines extent of PMSI using judicially adopted FIFO allocation principle); *King v. Citizens and Southern Nat. Bank* (*In re King*), 19 Bankr. 409 (Bankr. M.D. Ga. 1982) (series of refinancings combining purchase money and nonpurchase money advances and collateral; PMSI lost); *Booker v. Commercial Credit Corp.* (*In re Booker*), 9 Bankr. 710 (Bankr. M.D. Ga. 1981) (security agreement executed at time of purchase money advance consolidates balance and collateral from earlier security agreement, which is not identified as either purchase money or nonpurchase money; PMSI lost under transformation rule); *In re Gibson*, 16 Bankr. 257 (Bankr. D. Kan. 1981) (court rejects transformation rule and adopts FIFO payment allocation principle); *Coomer v. Barclays Am. Fin. Inc.* (*In re Coomer*), 8 Bankr. 351 (Bankr. E.D. Tenn. 1980) (purchase money loan consolidated with earlier nonpurchase money debt and collateral in absence of contractual or legislative payment allocation rule; PMSI lost); *In re Simpson*, 4 U.C.C. Rep. Serv. (Callaghan) 250 (Bankr. W.D. Mich. 1966) (initial nonpurchase money debt and collateral included in second security agreement at time of purchase money advance; PMSI lost).

nancing, makes a new nonpurchase money advance to the debtor²³⁵ or consolidates nonpurchase money debt with purchase money debt.²³⁶

In most of the cases, however, the refinancing produces the functional equivalent of cross-collateralization. Consolidated debt is secured by all remaining collateral. In this situation, the courts often conclude, each item of collateral secures more than "its price."²³⁷ What else the item of collateral secures, of course, may be the "price" of other (originally purchase money) collateral,²³⁸ or in some cases, new cash advances²³⁹ or other debts or charges which have been folded in to the consolidated debt.²⁴⁰ The response of the courts, as in the consumer add-on cases, forms a patchwork of transformation rule cases and dual status rule cases.²⁴¹

4. The Nature of the "Its Price" Argument and the Most Common Reply

Regardless of the context in which it is used, however, the argument based on the "its price" language of U.C.C. section 9-107(a) is essentially an appeal to the "plain meaning" of a text. Indeed, it is an instance of placing overwhelming weight on the occurrence of a single possessive pronoun (*i.e.*, "its price"). The most common qualification of it is likewise a textual argument. In a number of the refinancing cases, the courts make use of the same argument used by the *Pristas* court in the context of consumer "add on" provisions. If the "its price" language of U.C.C. section 9-107(a) must be given full force, so must the phrase "to the extent," which appears in the opening clause of U.C.C. sec-

235. See, e.g., *Billings v. Avco Colorado Industrial Bank (In re Billings)*, 838 F.2d 405 (10th Cir. 1988) (new advance \$9.67; court adopts dual status rule); *In re Kruse*, 116 Bankr. 708 (D. Neb. 1990) (additional advance without refinancing; PMSI sustained because debtor made no payments after second advance); *In re Johnson*, 101 Bankr. 280 (Bankr. W.D. Okla. 1989) (dual status rule applied, relying, without discussion, on prior cases); *In re Snipes*, 86 Bankr. 1006 (Bankr. W.D. Mo. 1988) (PMSI lost); *In re Geist*, 79 Bankr. 939 (D. Wyo. 1987) (dual status rule adopted); *In re Schwartz*, 52 Bankr. 314 (Bankr. E.D. Pa. 1985) (dual status rule); *Russell v. Associates Fin. Servs. of Okla., Inc. (In re Russell)*, 29 Bankr. 270 (Bankr. W.D. Okla. 1983) (dual status rule); *Associates Fin. v. Conn (In re Conn)*, 16 Bankr. 454 (Bankr. W.D. Ky. 1982) (dual status rule; FIFO payment allocation); *Stevens v. Associates Fin. Servs. (In re Stevens)*, 24 Bankr. 536 (Bankr. D. Colo. 1982) (dual status rule; FIFO payment allocation); *In re Gibson*, 16 Bankr. 257 (Bankr. D. Kan. 1981); (dual status rule; FIFO payment allocation); *In re Jones*, 5 Bankr. 655 (Bankr. M.D.N.C. 1980) (PMSI lost); *Slay v. Pioneer Credit Co. (In re Slay)*, 8 Bankr. 355 (Bankr. E.D. Tenn. 1980) (court expresses approval of transformation rule generally but applies dual status rule where lack of payments by debtor makes determination of extent of PMSI possible).

236. See, e.g., *In re Geist*, 79 Bankr. 939 (D. Wyo. 1987) (dual status rule); *In re Johnson*, 101 Bankr. 280 (Bankr. W.D. Okla. 1989) (dual status rule applied, relying, without discussion, on prior cases); *In re Snipes*, 86 Bankr. 1006 (Bankr. W.D. Mo. 1988) (PMSI lost); *In re Harrell*, 72 Bankr. 107 (Bankr. N.D. Ala. 1987) (PMSI lost); *In re Yokley*, 42 Bankr. 575 (Bankr. N.D. Ala. 1984) (PMSI lost; no discussion of reasons); *Fickey v. Bank of LaFayette (In re Fickey)*, 23 Bankr. 586 (Bankr. E.D. Tenn. 1982) (addition of refinancing charges destroy PMSI, in absence of payment allocation provisions); *Kelley v. United Am. Bank in Knoxville (In re Kelley)*, 17 Bankr. 770 (Bankr. E.D. Tenn. 1982) (PMSI lost); *King v. Citizens and Southern Nat. Bank (In re King)*, 19 Bankr. 409 (Bankr. M.D. Ga. 1982) (PMSI lost); *In re Luczak*, 16 Bankr. 743 (Bankr. W.D. Wis. 1982) (PMSI lost in absence of payment allocation provision); *In re Gibson*, 16 Bankr. 257 (Bankr. D. Kan. 1981) (dual status rule and FIFO payment allocation); *Coomer v. Barclays Am. Fin. Inc. (In re Coomer)*, 8 Bankr. 351 (Bankr. E.D. Tenn. 1980) (PMSI lost in absence of payment allocation formula).

237. See *supra* notes 232-35.

238. See *supra* note 232.

239. See *supra* note 234.

240. See *supra* note 235.

241. See *supra* notes 232-35.

tion 9-107. The statement that a security interest is purchase money "to the extent" it satisfies subsection (a) or (b) seems to contemplate that a security interest may be partly purchase money in status and partly a garden-variety security interest. Therefore, even if the argument based on the phrase "its price" is correct, it should not result in a total loss of purchase money status. As long as there is some basis for apportioning debt and collateral into purchase money and nonpurchase money components (in light of the debtor's payments), such a separation should be made and the purchase money privileges preserved for the appropriate portion.²⁴²

The leading candidates for the basis for such apportionment include allocation of payment formulae in the security agreement itself,²⁴³ allocation formulae from applicable or analogous statutes,²⁴⁴ or judicially adopted "tracing"

242. See, e.g., *Billings v. Avco Colorado Industrial Bank (In re Billings)*, 838 F.2d 405 (10th Cir. 1988); *Pristas v. Landaus of Plymouth (In re Pristas)*, 742 F.2d 797 (3rd Cir. 1984); *In re Geist*, 79 Bankr. 939 (D. Wyo. 1987); *In re Hemington*, 84 Bankr. 604 (Bankr. D. Minn. 1988); *Bond's Jewelers, Inc. v. Linklater (In re Linklater)*, 48 Bankr. 916 (Bankr. D. Nev. 1985); *Greenville Inc. v. McCall (In re McCall)*, 62 Bankr. 57 (M.D. Ala. 1985); *In re Nolen*, 53 Bankr. 235 (Bankr. M.D. Tenn. 1985) (dictum); *In re Schwartz*, 52 Bankr. 314 (Bankr. E.D. Pa. 1985); *Russell v. Associates Fin. Servs. of Okla., Inc. (In re Russell)*, 29 Bankr. 270 (Bankr. W.D. Okla. 1983); *In re Sprague*, 29 Bankr. 711 (Bankr. M.D. Pa. 1983); *Associates Fin. v. Conn (In re Conn)*, 16 Bankr. 454 (Bankr. W.D. Ky. 1982); *In re Hobdy*, 18 Bankr. 70 (Bankr. W.D. Ky. 1982); *Credithrift of America v. Littlejohn (In re Littlejohn)*, 20 Bankr. 695 (Bankr. W.D. Ky. 1982); *Ever Ready Machinists, Inc. v. Relpak Corp. (In re Relpak Corp.)*, 25 Bankr. 148 (Bankr. E.D.N.Y. 1982); *Stevens v. Associates Fin. Servs. (In re Stevens)*, 24 Bankr. 536 (Bankr. D. Colo. 1982); *In re Wilson*, 25 Bankr. 276 (Bankr. D. Neb. 1982); *In re Gibson*, 16 Bankr. 257 (Bankr. D. Kan. 1981); *Meadows v. Household Retail Servs. (In re Griffin)*, 9 Bankr. 880 (Bankr. N.D. Ga. 1981). But see, e.g., *Matthews v. TransAmerica Fin. Servs. (In re Matthews)*, 724 F.2d 798 (9th Cir. 1984), reversing *In re Matthews*, 20 Bankr. 654 (Bankr. App. 9th Cir. 1982) (appellate court reverses bankruptcy appellate panel's adoption of dual status rule); *In re Snipes*, 86 Bankr. 1006 (Bankr. W.D. Mo. 1988) (transformation rule applied; *Pristas* analysis rejected); *Franklin v. ITT Fin. Servs. (In re Franklin)*, 75 Bankr. 268 (Bankr. M.D. Ga. 1986) (FIFO allocation provision in security agreement does not save PMSI); *In re Mason*, 46 Bankr. 119 (Bankr. E.D. Mich. 1985) (court refuses to supply a payment allocation rule when parties have not done so; PMSI lost); *Coomer v. Barclays Am. Fin. Inc. (In re Coomer)*, 8 Bankr. 355 (Bankr. E.D. Tenn. 1980) (same).

243. See *Greenville Inc. v. McCall (In re McCall)*, 62 Bankr. 57 (M.D. Ala. 1985) (FIFO allocation provision included in contract); *Bond's Jewelers, Inc. v. Linklater (In re Linklater)*, 48 Bankr. 916 (Bankr. D. Nev. 1985) (FIFO payment allocation by contract); *Keller v. Household Finance Corp. Retail Services (In re Keller)*, 29 Bankr. 91 (Bankr. M.D. Fla. 1983) (FIFO by contract); *In re Mattson*, 20 Bankr. 382 (Bankr. W.D. Wis. 1982) (FIFO by contract); *In re Wilson*, 25 Bankr. 276 (Bankr. D. Neb. 1982) (FIFO by contract). See also *Goodyear Tire & Rubber Co. v. Staley (In re Staley)*, 426 F. Supp. 437 (M.D. Ga. 1977) discussed at *supra* note 231.

244. See, e.g., *Pristas v. Landaus of Plymouth, Inc. (In re Pristas)*, 742 F.2d 797 (3rd Cir. 1984) (state statute providing for pro rata payment allocation according to ratio of original cash sale prices); *In re Nolen*, 53 Bankr. 235 (Bankr. M.D. Tenn. 1985) (state statute permitting cross-collateralization and allocating payments according to FIFO rule); *Breakiron v. Montgomery Ward (In re Breakiron)*, 32 Bankr. 400 (Bankr. W.D. Pa. 1983) (state statute mandating pro rata allocation according to ratio of original cash sale prices); *Schewel Furniture Co. v. Goard (In re Goard)*, 26 Bankr. 316 (Bankr. M.D.N.C. 1982) (state statute providing for pro rata payment allocation according to original cash sale prices); *In re Gibson*, 16 Bankr. 257 (Bankr. D. Kan. 1981) (FIFO by statute (the Uniform Consumer Credit Code) in case of conditional sellers; FIFO by judicial adoption for lenders); *In re Brouse*, 6 U.C.C. Rep. Serv. (Bankr. W.D. Mich. 1969) (state statute providing for pro rata payment allocation according to original cash sale price). But see, e.g., *In re Mason*, 46 Bankr. 119 (Bankr. E.D. Mich. 1985) (court declines to apply payment allocation provision of Retail Installment Sales Act to third party lender); *In re Beasley*, 23 Bankr. 404 (Bankr. E.D.N.C. 1982) (when creditor fails to incorporate provisions of state statute in contract, all but last PMSI in consolidation lost); *Butterworth Furniture Co. v. Penny (In re Penny)*, 15 Bankr. 124 (Bankr. E.D. Va. 1981) (series of purported PMSI's held void for failure to elect one of two payment allocation provisions permitted by state statute); *Coronado v. Beach Furniture and Appliance, Inc. (In re Coronado)*, 7 Bankr. 53 (Bankr. D. Ariz. 1980) (PMSI lost where consolidated security agreements failed

rules.²⁴⁵ Judicial tracing rules, in turn, could either consist of a single across-the-board rule (such as FIFO) or the more traditional battery of common law tracing rules (e.g., application of payments first to the most precarious debt).²⁴⁶

5. *Another Possible Response: Distinguishing U.C.C. Section 9-107(a) and (b)*

As noted above, the "to the extent" argument is neither a refutation of the claim that purchase money collateral may not secure more than "its price" nor a fatal blow to the transformation rule. It is merely an attempt to confine the transformation rule by expanding the range of situations in which one is able to determine how much of "its price" is still included in the total debt.

One could go even further in confining the "its price" argument on a textual basis. One could argue, for example, that the phrase "its price" occurs only in U.C.C. section 9-107(a), not in section 9-107(b). Therefore, it is perhaps arguable that the conditional seller, who is covered by subsection (a), is subject to the transformation rule, but the third party lender who finances the acquisition of an asset is not. The "in fact so used" language of subsection (b) may, indeed, mean that the purported purchase money lender must be able to show that his advance was used to acquire assets for the debtor, and it may even mean that the total purchase money debt may not exceed the sum of the prices of the assets purchased. It does not appear to require that purchase money debt be segmented into the "prices" of the various items purchased at one time, or that such segmentation be maintained for items purchased at different times. Therefore, even if cross-collateralization is precluded for the conditional seller, the third party inventory financier is not prevented from entering into limited cross-collateralization agreements like the Felicitous/Larry agreement found in Paradigm 2. Under such an interpretation, even if *Manuel* is correct, *South-trust* is wrong.

to include payment allocation method provided by statute); *W.S. Badcock Corp. v. Banks* (*In re Norrell*), 426 F. Supp. 435 (M.D. Ga. 1977) (statutory payment allocation formula does not save PMSI under add-on clauses).

245. See, e.g., *In re Moore*, 33 Bankr. 72 (Bankr. D. Or. 1983) (court requires application of payments to purchase money debt in amount equal to payments under original purchase money agreement); *Russell v. Associates Fin. Servs. of Okla., Inc.* (*In re Russell*), 29 Bankr. 270 (Bankr. W.D. Okla. 1983) (court adopts FIFO allocation rule); *In re Sprague*, 29 Bankr. 711 (Bankr. M.D. Pa. 1983) (FIFO allocation rule in most cases; in some cases, application of payments to debt least secured); *Associates Fin. v. Conn* (*In re Conn*), 16 Bankr. 454 (Bankr. W.D. Ky. 1982) (judicially adopted FIFO allocation rule); *Stevens v. Associates Fin. Servs.* (*In re Stevens*) 24 Bankr. 536 (Bankr. D. Colo. 1982) (court adopts FIFO); *In re Gibson*, 116 Bankr. 257 (Bankr. D. Kan. 1981) (where conditional sellers governed by statutory FIFO allocation rule, court adopts same rule for lenders). But see *Rosen v. Associates Fin. Servs. Co.*, 17 Bankr. 436 (D.S.C. 1982) (court declines to disentangle purchase money and nonpurchase money aspects of transaction); *Hipps v. Landmark Fin. Servs. of Ga., Inc.* (*In re Hipps*) 89 Bankr. 264, 266 (Bankr. N.D. Ga. 1988) (court declines to apply dual status rule because of "accounting nightmare"); *Booker v. Commercial Credit Corp.* (*In re Booker*), 9 Bankr. 710, 712 (Bankr. M.D. Ga. 1981) (court declines to "sift through facts" to determine what is purchase money collateral); *Fickey v. Bank of LaFayette* (*In re Fickey*), 23 Bankr. 586 (Bankr. E.D. Tenn. 1982) (PMSI transformed where contract itself did not provide payment allocation method); *Slay v. Pioneer Credit Co.* (*In re Slay*), 8 Bankr. 355 (Bankr. E.D. Tenn. 1980) (normally, court will not separate a "mass of transactions"; dual status rule applied, however, where debtor had made no payments). See also *General Electric Credit Corp. v. Allegretti*, 161 Ill. App. 3d 853, 515 N.E.2d 721 (1987).

246. See *Lloyd*, *supra* note 8, at 87-89; *Marshall*, *supra* note 203, at 157.

The argument of the preceding paragraph effectively drives a wedge between subsections (a) and (b) of U.C.C. section 9-107. In spite of its plausibility as a matter of textual interpretation, the suggestion that subsections (a) and (b) are informed by different policies and generate different rules is one which secured creditors have an incentive to avoid. The reasons are suggested, in a somewhat different context, by Professor McLaughlin.²⁴⁷

Whether he is a conditional seller under subsection (a) or a third party financier under subsection (b), a purchase money creditor undoubtedly expects to have interest or finance charges and any sale-related expenses included in the purchase money debt. There are good reasons for permitting the conditional seller governed by U.C.C. section 9-107(a) to do this.²⁴⁸ The conditional seller in a credit transaction will normally compute and set out in the sale contract a credit price (including finance charge and any incidental expenses) which is different from the price he would charge in a cash transaction. It is the debtor's agreement to pay the full credit price which enables him to acquire the asset(s) sold, and it is therefore plausible to argue that the "price" of section 9-107(a) is the credit price and that purchase money debt legitimately includes finance charges.

It is far more difficult to make the same argument on behalf of the third party financier under the text of U.C.C. section 9-107(b).²⁴⁹ Typically, such a lender pays the seller of the collateral directly for goods acquired by the debtor. The "value" which is thus "in fact used" to enable the debtor to acquire rights in or use of collateral is most plausibly identified with such a payment. Normally, however, such a payment will be a payment of the seller's cash price; finance or interest charges accrue later, after the debtor has acquired the asset(s). It is thus most difficult to regard interest charges as part of the "value" enabling the debtor to "acquire rights in or the use of" the collateral, and it is correspondingly difficult to argue interest charges should be part of the purchase money debt. The escape for the third party financier is to argue that subsections (a) and (b) of U.C.C. section 9-107 are justified by the same rationale and should be interpreted to authorize similar sorts of transactions whether the purchase money creditor is a conditional seller or a third party lender. If that is true (and it seems unassailable), the third party lender governed by subsection (b) should be able to include interest or finance charges in purchase money debt. However, he also becomes vulnerable to the attack on cross-collateralization based on the "its price" language of U.C.C. section 9-107(a).

247. McLaughlin, *Qualifying as a Third-Party Purchase-Money Financier: The Hurdles to Be Cleared, the Advantages to Be Gained*, 13 U.C.C. L.J. 225, 236-37 (1981) [hereinafter, "McLaughlin, Purchase Money"]; McLaughlin, *"Add On" Clauses in Equipment Purchase Money Financing: Too Much of a Good Thing*, 49 *FORD. L. REV.* 661, 673, 700-03 (1981) [hereinafter, "McLaughlin, 'Add On' Clauses"]. For a somewhat different argument against asymmetrical interpretations of § 9-107(a) and (b), see Beard, *supra* note 203, at 452-55.

248. See McLaughlin, *"Add On" Clauses*, *supra* note 247, at 665-73 for a more complete statement of the argument. Indeed, Professor McLaughlin would go further and include in purchase money debt certain post-sale expenses for the purposes of preserving the value of the collateral, protecting the seller's interest, or collecting the secured debt. *Id.* at 673-77, 703-04.

249. McLaughlin, *"Add-On" Clauses*, *supra* note 247, at 701, 703.

6. *Dissimilar Treatment of Functionally Equivalent Transactions*

Felicitous Finance and Felonious Finance thus have every incentive to meet the "its price" argument head-on. Felicitous, as a financier of fungible widgets, has perhaps the most obvious opening gambit. Suppose the wholesale cost of widgets is one dollar. Suppose further that on January 1, Felicitous finances Larry's purchase of 60,000 widgets from the Midget Widget Co., and that on February 1, Felicitous finances the purchase of another 60,000 widgets from the same supplier. Larry misses the 20,000 dollar payment that falls due on February 1 under the thirty-sixty-ninety day payment scheme imposed by the security agreement. In mid-March, after another 20,000 dollars from the first advance and 20,000 dollars from the second advance have fallen due, Larry manages to pay 20,000 dollars to Felicitous. Thereafter, Larry suffers financial reverses and makes no further payments. On July 1, Larry files a petition for relief under Chapter 7 of the Bankruptcy Code. In the meantime, Larry has sold 20,000 widgets, so that 100,000 remain on hand.

Under *Southtrust* and *Manuel*, Felicitous has forfeited purchase money status. While *Southtrust* leaves open the possibility that Felicitous may have been a purchase money creditor on January 1, the February 1 advance triggered the future advance aspect of the cross-collateralization provision, destroying the purchase money security interest. As there is no contractual allocation of payments formula, purchase money status cannot be preserved even assuming the *Southtrust* court would apply the dual status rule in the presence of such a formula. Therefore, Bucolic Bank, the prior perfected floating lienor, has first claim to the widgets remaining, and may sell all 100,000 and apply the proceeds to its debt.

A dramatically different result can be produced, however, by changing a single fact in the foregoing pattern. If, instead of two 60,000 dollar advances and widget purchases, Felicitous advances 120,000 dollars on January 1 for the purchase of 120,000 widgets, and all else remains the same as above, the result is reversed. Felicitous is now a perfected purchase money creditor, and its security interest in the 100,000 widgets on hand on July 1 primes that of Bucolic Bank under U.C.C. section 9-312(3). It is unjust, Felicitous might argue, that such a slight difference in the form of the transaction should make such a dramatic difference in the collectibility of its debt.²⁵⁰

7. *Is The "Its Price" Argument Nonsensical?*

Indeed, it is possible for Felicitous to make an even more fundamental objection to the argument that purchase money collateral may not secure more than "its price." It can be argued that the "its price" argument is nonsensical. Suppose, once again, that Felicitous makes a single advance of 60,000 dollars on January 1 for Larry's purchase of 60,000 widgets. Larry sells 20,000 widgets between January 1 and February 1, and in mid-March he makes a 20,000 dollar payment. Money and individual dollar values of debt are fungible, and so

250. A similar but more abbreviated example appears in Marshall, *supra* note 203, at 153-54.

are widgets. It would therefore be laughable for Bucolic Bank to argue that its own security interest in 20,000 of the 40,000 widgets remaining in Larry's possession was superior to that of Felicitous because, as it happened, the 20,000 dollar payment paid off "the price" of 20,000 of the widgets still in Larry's possession (thereby releasing them from Larry's security interest), while the 20,000 widgets which were sold were really the collateral for half of Felicitous' remaining 40,000 dollar debt (which is now, coincidentally, half unsecured). There is no rational basis for dividing the original 60,000 dollar debt into segments, sorting the widgets into sub-piles, assigning a debt segment to each sub-pile and forcing Larry to guess which sub-pile will be sold first or to which debt segment to apply the initial payment. Clearly, as of February 15, Felicitous has a purchase money security interest in all 40,000 widgets remaining in Larry's inventory.

If so, however, it is difficult to see why the result should be different if the transaction is simply spread out over time. If it is once again assumed that Felicitous makes a second 60,000 dollar advance for widget purchases on February 1, and no payments are made except a 20,000 dollar payment in mid-March, it makes no more sense, on Larry's July 1 insolvency, to say that the "price" of some of the collateral on hand may have been paid off, and, since neither Larry nor Felicitous can tell us which widgets are paid off, Felicitous must be subordinated. Once the debt from the two advances is consolidated, there is only a single purchase money debt. There is no separate accounting entry for "the price" of each batch of widgets and, indeed, no way Larry can tell which advance purchased any given widget. Neither the consolidated debt nor the collateral can rationally be individuated into segments, and so a particular widget cannot be matched to one segment (or, for that matter, to more than one). Therefore, it is nonsensical to ask whether a widget secures more than "its price," if what is required is an assignment of a widget to a debt-segment. "Its price" no longer exists as some kind of separate entity like a table or a chair; to suppose it does is simply bad metaphysics. Thus, the argument that cross-collateralization of purchase money debt is not permissible because it would allow purchase money collateral to secure more than "its price" is founded on conceptual confusion.²⁵¹

In its present form, however, Felicitous' argument goes too far. In particular, it depends upon the premise that, if there is no empirical basis (e.g., accounting entries) for separating purported purchase money debt into segments corresponding to the "price" of each item of collateral, it is meaningless to speak of such segments or "prices." This sounds a great deal like logical positivism, which, in its extreme form, identified the meaning of a sentence with the

251. Hints of this sort of argument can be discerned in one of the early critiques of the *Southtrust* case. See Smith, *Secured Transactions*, 41 BUS. LAW. 1463, 1485 (1986) (suggesting that a "pooling" concept is inherent in Article 9). See also *Borg-Warner Acceptance Corp. v. Tascosa Nat'l Bank*, 784 S.W.2d 129 (Tex. App. 1990). *Tascosa* is the only case in which a purchase money inventory financing arrangement with an express cross-collateralization feature has been sustained against a challenge based upon the *Southtrust* case. The court's opinion is not entirely clear, but it appears the court regarded a security interest in inventory as inherently incompatible with "item by item" analysis and thus, by its nature, suitable for a collateral pooling arrangement. *Id.* at 134, 135. See also *Beard*, *supra* note 203, at 494-95.

set of empirical propositions which would verify or refute it.²⁵² Logical positivism is now decidedly out of favor among philosophers,²⁵³ and most legal scholars would likewise resist it.²⁵⁴ It is therefore unlikely that Felicitous may dismiss the question whether purchase money collateral secures more than "its price" as mere gibberish.

8. *The Demands of Theoretical Economy and Fairness*

Nevertheless, Felicitous may simply recast its argument in the form of a demand for theoretical economy instead of an attack on the meaningfulness of the argument based on the phrase, "its price." Perhaps Felicitous must concede that speaking of the segments of a consolidated purchase money debt corresponding to the price of each item of purchase money collateral is not nonsense; it is, however, more than a little complicated. Indeed, even under the benign influence of the dual status rule, which does not eliminate the possibility of cross-collateralization entirely, a secured creditor like Felicitous who makes more than a single advance has done something enormously cumbersome. At the first advance, Felicitous creates a purchase money security interest in the initial batch of collateral purchased with its funds. At the second advance, Felicitous creates a second purchase money security interest in the second batch of collateral. At the same time, however, the first advance becomes secured by an ordinary security interest in the second batch of collateral, and the second advance likewise becomes secured by an ordinary security interest in whatever remains of the first batch of collateral.²⁵⁵ Depending on which collateral is sold and to which advance any repayments by Larry are applied, Felicitous could end up with a first priority purchase money security interest in all remaining collateral, a second priority ordinary security interest in all remaining collateral, or some mixture of ordinary and purchase money security interests in various portions of the collateral.

At this point, unless Felicitous wishes simply to assume the risk of complete or partial loss of security, it must undertake the more extensive accounting and monitoring characteristic of the Formalist/Moe agreement of Paradigm 1, and whatever economic benefit may have been thought to accrue from Paradigm 2 has been lost.²⁵⁶ If, however, the effect of the "its price" argument is to force the apparently simpler Paradigm 2 to fit the mold of Paradigm 1, Felicitous has good grounds to ask what theoretical purpose such a forced merger serves. Why must purchase money debt be divided into price segments and

252. See generally A.J. AYER, LANGUAGE, TRUTH, AND LOGIC (1952). Carnap, *The Rejection of Metaphysics*, 20TH CENTURY PHILOSOPHY: THE ANALYTIC TRADITION, 206 (M. Weitz ed. 1966).

253. See LOGIC AND LANGUAGE, 2nd Series (A. Flew ed. 1959).

254. Lloyd, for example, would clearly resist it. In a somewhat different context, he cautions against confusing a tangible promissory note with the debt of which it is evidence. See Lloyd, *supra* note 8, at 58.

255. Both Lloyd and McLaughlin appear to accept this view. See Lloyd, *supra* note 8, at 97n. 435. McLaughlin, "Add On" Clauses, *supra* note 247, at 693-95. See also Note, *Preserving the Purchase Money Status of Refinanced or Commingled Purchase Money Debt*, 35 STAN. L. REV. 1133, 1160 n.97 (1983).

256. See also Lloyd, *supra* note 8, at 97-98 n.435 (suggesting a release price system of similar complexity).

paired with individual items (or perhaps groups)²⁵⁷ of collateral? Why, if any form of cross-collateralization is attempted, must each segmented purchase money security interest be assigned a "shadow" ordinary security interest? What theoretical purpose is served by insisting on such a conceptual apparatus, as opposed to conceiving the Felicitous/Larry agreement as a single purchase money debt (which grows or shrinks over time as enabling advances are made or payments are received) secured by a single pool of purchase money collateral, acquired at different times (but all financed initially by Felicitous)? In short, if Felicitous may not prevail by using logical positivism, it may nevertheless invoke Ockham's Razor²⁵⁸ and demand justification for theoretical complexity.

The mere occurrence of the phrase "its price" in U.C.C. section 9-107(a) cannot provide the justification of the additional theoretical complexity imposed by the transformation rule (or, for that matter, the dual status rule). As noted above, there is every reason to construe subsections (a) and (b) of section 9-107 consistently, and subsection (b) does not define purchase money debt in terms of all or a portion of the "price" of collateral. Rather, it appears to identify purchase money debt more loosely with the "value" which is "in fact used" to enable the debtor to acquire rights or use of collateral. Indeed, as examples of such "value," subsection (b) recites both "making advances" (in the plural) or "incurring an obligation" (singular). If any inference can be drawn at all, the best inference from the language of subsection (b) would seem to be that the drafters were indifferent as to whether the purchase money debt secured by a single pool of purchase money collateral consisted of a single advance or a series of enabling advances over time. There is nothing in the Official Comments to section 9-107 or its drafting history that would require a more restrictive interpretation of (b) or that gives direct support to the extremely restrictive gloss on the "its price" language of (a) given by *Manuel* and *Southtrust*. The text of section 9-107, therefore, is not conclusive evidence for a requirement of purchase money debt subdivision and one-to-one pairing with collateral.

Indeed, there would seem to be no theoretical benefit for the conceptual complexity which effectively precludes the apparently simple Felicitous/Larry limited cross-collateralization arrangement. If the Felicitous/Larry agreement is enforced as written, Felicitous has a first priority purchase money security interest in whatever widgets Larry has on hand (provided they were initially

257. The ambiguity in the text is deliberate. One of the early criticisms of *Southtrust* was that it failed to specify the proper focus of the "one-to-one" correspondence between debt and collateral. To use the example in the text, must Larry segment the initial advance into \$1 components and match each component with a single widget? Or will it suffice if a separate record of the initial \$60,000 advance is kept and it is matched to the pile of 60,000 widgets purchased on January 1? Parallel questions arise for the allocation of Larry's single repayment. None of these questions are answered by the transformation rule cases. See Smith, *Secured Transactions*, 41 BUS. LAW. 1463, 1485-86 (1986).

258. Ockham's Razor is commonly said to be the principle that "entities are not to be multiplied without necessity." Oddly enough, though its alleged author, the fourteenth century philosopher, William of Ockham, was indeed a proponent of theoretical economy, he apparently never formulated the principle precisely in those terms. See Moody, *William of Ockham*, 8 THE ENCYCLOPEDIA OF PHILOSOPHY 306, 307 (1967). The formulations of the principle which can be traced to Ockham include "Plurality is not to be assumed without necessity" and "What can be done with fewer [assumptions] is done in vain with more." *Id.* at 307.

purchased with Felicitous funds) until the entire Felicitous debt (all of which consisted of purchase money advances) is paid. In that sense, Felicitous' lien "floats" over the purchase money collateral. If, on the other hand, a requirement is imposed that Felicitous subdivide its debt into the price of each item (or the price of a set of items purchased at the same time) and forever correlate items (or sets) of collateral accordingly, the only possible benefit is to the prior floating lienor, Bucolic Bank.²⁵⁹ If a strict transformation rule is adopted, Felicitous' purchase money security interest in the entire body of collateral is subordinated to Bucolic's perfected floating lien as soon as Felicitous' second advance is made.²⁶⁰

If the dual status rule is adopted, the extent of Felicitous' subordination depends on the allocation of payment formula chosen (by agreement, statute or judicial decision) and the order in which inventory is sold. To modify a previous example, suppose Felicitous has made two advances of 60,000 dollars on January 1 and February 1, respectively, that each advance was used to buy 60,000 widgets, and that 20,000 widgets from the second batch acquired have been sold. Suppose again that Larry has missed the February payment, but that on March 15 (when 40,000 dollars from the first advance and 20,000 advance from the second are already due) Larry pays 20,000 dollars. Larry makes no further payments until July (at which point the entire remaining 100,000 dollar debt is due). Larry then sells 40,000 widgets from the first batch and pays 40,000 dollars. If payments are allocated to the oldest debt under a "first-in, first-out" ("FIFO") rule, the entire 60,000 dollar first advance has been repaid, extinguishing Felicitous' purchase money security interest in the remaining 20,000 widgets from the first group. Bucolic Bank's floating lien "recaptures" them, in the sense that Bucolic Bank now has the first priority security interest in them.²⁶¹ Meanwhile the entire second advance is entirely unpaid, but only 40,000 of the second batch of widgets remain to secure it. As to that 40,000, Felicitous has purchase money priority, but it is obviously undersecured.

If payments are allocated first to the newest debt, the second advance is fully repaid and Felicitous' security interest in the 40,000 widgets from the second batch is lost. Priority in those widgets once again reverts to Bucolic under its floating lien. Felicitous is left with a balance of 60,000 dollars on the first advance secured by a purchase money security interest in 20,000 widgets remaining in the first batch.

If payments are allocated pro rata according to the size of the initial advance (*i.e.*, equally to each advance), Felicitous is ultimately left with an outstanding debt of 30,000 dollars on each advance, secured by 20,000 widgets, in the case of the first advance, and 40,000 widgets, in the case of the second advance. Moreover, even if widgets have held all of their original value (a

259. See Lloyd, *supra* note 8, at 91.

260. See *supra* notes 199-202 and accompanying text.

261. Under the dual status rule, if Felicitous has attempted to cross-collateralize, it retains an ordinary, non-purchase money security interest in the first group of widgets to secure the second advance, but that ordinary security interest is subordinate to Bucolic Bank's under § 9-312(5). For a similar example in the context of equipment financing, see McLaughlin, "Add On" Clauses, *supra* note 247, at 693-95. See also Lloyd, *supra* note 8, at 97 n.435.

highly dubious assumption) on foreclosure and resale, Felicitous must account to Bucolic for the proceeds of the second batch in excess of Felicitous' 30,000 dollar debt and simply absorb the 10,000 dollar loss resulting from the under-secured status of the first advance.²⁶² Felicitous' (partial) loss is Bucolic's gain.

Moreover, if, by hypothesis, Bucolic Bank is simply removed from the picture, the lack of any theoretical advantage to the conceptual complexity required by the argument based on the phrase "its price" becomes even more apparent. In the absence of a prior floating lienor, even the transformation rule makes no difference. The only effect of the transformation rule is to deprive Felicitous of purchase money priority; Felicitous retains an ordinary security interest,²⁶³ and there is no question that cross-collateralization is permitted in the case of ordinary perfected security interests.²⁶⁴ As there is no prior floating lienor, and because no subsequent secured creditor can gain priority over Felicitous as to the widgets it has already purchased for Larry, Felicitous need not be concerned with rival secured creditors. Unsecured creditors are no threat, since Felicitous' security interest is perfected.²⁶⁵ And Felicitous' security interest would be enforceable against Larry even if it were not perfected.²⁶⁶

Thus, if the use of the term "its price" in U.C.C. section 9-107(a) is interpreted to impose a requirement of purchase money debt subdivision and collateral pairing, so as to preclude limited cross-collateralization arrangements like Paradigm 2, the effect of the resulting theoretical complexity is either nothing whatsoever or a rather straightforward windfall to a prior floating lienor.

It is difficult to imagine why the purchase money provisions of the Code should be interpreted to favor the floating lienor. His initial collateral pool has not been invaded. The only real protection the floating lienor needs is some device to prevent him from making a new nonpurchase money advance against newly-acquired purchase money collateral, and the notice required by U.C.C. section 9-312(3) serves that purpose admirably.

Moreover, under the conventional justification for purchase money priority, it is the floating lienor's "stranglehold" that is sought to be broken, not fostered.²⁶⁷ Similarly, allowing the floating lienor to recapture purchase money collateral under the *Southtrust* rule potentially offers a partial reinstatement of the floating lienor's "situational monopoly."²⁶⁸ The fairness rationale for purchase money priority is likewise undermined since, as noted above, the preclusion of limited cross-collateralization permits the prior floating lienor to recapture collateral purchased with funds supplied by the purchase money creditor at the same time the purchase money creditor takes a loss on purchase money debt which happened to originate in a different advance.²⁶⁹

262. See U.C.C. §§ 9-502, 9-504.

263. See *Southtrust v. Borg-Warner Acceptance Corp.*, 760 F.2d 1240, 1243.

264. See *supra* notes 1-2, 68-90 and accompanying text.

265. See *supra* notes 61-66 and accompanying text.

266. U.C.C. §§ 9-201, 9-301.

267. See *supra* notes 107-11 and accompanying text.

268. See *supra* notes 158-69 and accompanying text.

269. See *supra* notes 112-13, 259-62 and accompanying text.

Indeed, there are additional reasons of fairness to permit the purchase money inventory financier to enter into limited cross-collateralization arrangements. Inventory is rather precarious collateral from the outset. By definition, it is held for sale or use in a business.²⁷⁰ In the case of retail or wholesale business inventory, the debtor's purpose in acquiring it is obviously to sell it. When inventory is sold to a buyer in the ordinary course of business, however, an inventory financier's security interest (purchase money or ordinary) is lost.²⁷¹

The inventory financier fares little better with the proceeds of his original collateral. When inventory is sold, even the purchase money inventory financier's priority is preserved only in the identifiable proceeds of cash sales.²⁷² Credit sales (which presumably constitute the majority of commercial sales)²⁷³ may generate accounts or chattel paper as proceeds, and the priority of a purchase money inventory financier does not automatically carry over to accounts or chattel paper as proceeds.²⁷⁴ In this respect, the inventory financier is at a disadvantage compared to other secured creditors, although this disadvantage was a deliberate policy choice, at least in the case of subordinating the inventory financier to rival accounts receivable financiers.²⁷⁵

Even the purchase money inventory financier, therefore, cannot usually follow either the collateral itself, once it is sold, or the proceeds thereof. If, on top of those built-in and deliberate disadvantages, the purchase money inventory financier is required to segregate both debt and collateral according to the order in which debt is incurred and purchases are made, as well as provide a repayment allocation method at the inception of the agreement, the purchase money financier faces a virtually unavoidable slide into undersecured status. True, a widget seller like Larry might be able to adopt a FIFO repayment allocation method at the outset and then control the order in which widgets are sold. If widgets are like nails, Larry may be like the hardware store owner who can decide which nails will be sold first by deciding which will be displayed first. It is possible that Larry may thus be able to assure that collateral is sold in the same order as debt is liquidated.²⁷⁶

Curly the computer retailer, however, probably cannot. The order and timing of his sales of various brands and models depend on factors other than his own decision of "which box to empty into the bin."²⁷⁷ His slide toward an undersecured position will be difficult to avoid no matter what allocation rule he

270. U.C.C. § 9-109(4).

271. U.C.C. § 9-307(1).

272. U.C.C. § 9-312(3).

273. See 2 J. WHITE & R. SUMMERS, *supra* note 62, § 3-6 at 151.

274. U.C.C. § 9-312(3); Official Comments 3 and 8 to § 9-312; § 9-312(5) and (6); § 9-308(b).

275. See Official Comments 3 and 8 to § 9-312; § 9-308(b); 2 J. WHITE & R. SUMMERS, *supra* note 62, § 26-4 at 502-03. While the subordination of the purchase money inventory financier claiming chattel paper as proceeds to a rival good faith purchaser of chattel paper appears to be a straightforward implication of U.C.C. §§ 9-312(3) and 9-308(b), the drafters have not made it as obvious that this was a deliberate policy choice as they did in the case of protecting accounts receivable financiers. Indeed, Professor Kripke believes that the reversal of purchase money priority as to chattel paper claimed as proceeds was inadvertent, and he has been asked by the Permanent Editorial Board to study the problem. See Letter of Professor Homer Kripke to Mark B. Wessman dated January 2, 1990 (on file in the offices of the Ohio State Law Journal).

276. See Aronov, *supra* note 114 at 58.

277. See 2 J. WHITE & R. SUMMERS, *supra* note 62, § 26-5, at 510 for an example making the same point.

chooses because no single payment allocation rule can be guaranteed to correspond to the actual order in which collateral is sold.

In either case, no policy reason supports compounding the already somewhat disadvantaged position of the inventory financier.²⁷⁸ Indeed, since the theoretical complexity imposed by the "its price" argument does no theoretical work in the context of Paradigm 2, except possibly to give a covert and undesirable advantage to a prior floating lienor, it should be rejected.

It would therefore appear that the limited cross-collateralization arrangement of Paradigm 2 should be enforced as written. At least, the use of the phrase "its price" in U.C.C. section 9-107(a) does not preclude Larry and Felicitous from regarding the series of purchase money advances as a single debt secured by a single collateral pool consisting of all Felicitous-financed widgets. Does it follow that the full cross-collateralization arrangement found in Paradigm 3 should be permitted? The answer depends upon which variant of Paradigm 3 is considered.

In Variant A, *supra*, Curly and Felonious actually behave the same way Larry and Felicitous behave under the limited cross-collateralization agreement of Paradigm 2. The only difference is that the Curly/Felonious security agreement facially permits an even greater degree of cross-collateralization, although the parties never actually attempt to take advantage of the increased latitude. Thus, the question under Variant A of Paradigm 3 is whether an arrangement permissible as a matter of policy (for the reasons noted above) should be vitiated by drafting defects (if, indeed, the broader latitude allowed is assumed to be a defect) in the governing agreement. To give an affirmative answer would be to adopt a "transformation rule" in its starkest form; the mere presence of unrestricted future advance and after-acquired property clauses would result in a loss of purchase money status.

It is doubtful that such harsh treatment of Curly and Felonious (operating under Variant A) can be justified. There is some basis for an argument that Article 9 generally does not make form decisive. Indeed, "agreement" is defined in U.C.C. section 1-201(3) as "the bargain of the parties in fact," as reflected in language *and conduct*, and a "security agreement" is (naturally enough) defined in terms of the more generic "agreement."²⁷⁹ The substitution of the generic Article 9 security interest for the battery of pre-Code security devices²⁸⁰ likewise reflects a movement away from making form decisive. Yet an argument that form should not be exalted over substance is problematic in that there are areas in which the Code does attach some importance to matters of form.²⁸¹

278. Indeed, Professor Hansford has concluded that, under the *Southtrust* rule, the § 9-312(3) purchase money priority for inventory is virtually useless, except for isolated or sporadic sales. See Hansford, *supra* note 203, at 264.

279. See U.C.C. § 9-105(1)(f).

280. See *supra* notes 18-21 and accompanying text.

281. After all, if a nonpossessory financier of inventory wants to perfect his security interest he must file a form (*i.e.*, a financing statement), and if he wishes to attain purchase money status, he must mail out a form meeting fairly precise requirements (*i.e.*, a § 9-312(3) notice).

More importantly, as noted above,²⁸² the "to the extent" language of the opening clause of U.C.C. section 9-107, in the view of many courts²⁸³ and most commentators,²⁸⁴ authorizes hybrid (*i.e.*, part purchase money and part nonpurchase money) security interests created by a single agreement. Indeed, it is impossible to give *any* effect to that language otherwise. The result should not be worse for the secured creditor who never actually engages in conduct which would create the nonpurchase money component under such an agreement. Accordingly, Variant A of Paradigm 3 should be treated in the same way as Paradigm 2, *i.e.*, by recognizing the purchase money status of the limited cross-collateralization arrangement.

9. *The Residual Question of the Status of Variant B of Paradigm 3*

Variant B of Paradigm 3, however, has the potential to create more serious problems. The core of the problem is that the cross-collateralization provisions are not limited, in form or in practice, to purchase money debt or purchase money collateral. Thus, the clear purchase money advances for inventory are secured not only by the inventory purchased, but by the accounts, the old business equipment (the purchase of which was not enabled by Felonious), and the forklift. For reasons similar to those which favor the Larry/Felicitous agreement of Paradigm 2, there is probably little objectionable about consolidating the debt resulting from purchase money inventory advances and the advance enabling the purchase of the forklift, securing both with a single collateral pool consisting of the forklift and the inventory. However, if that purchase money debt is secured by the old business equipment, and if the purchase money priority attaches to Felonious' security interest in the old equipment, the result is objectionable on policy grounds. The old equipment may, after all, have been part of the original collateral for Bucolic Bank's loan. Allowing Felonious to bootstrap its interest in the old equipment to a position of priority over Bucolic, through the device of cross-collateralizing purchase money debt with collateral which was not initially purchase money collateral, would create the potential for "last in time, first in right" priority as to portions of Bucolic's original collateral pool. This is not required by (and probably violates) Lloyd's fairness principle and it certainly goes well beyond breaking Bucolic's stranglehold over its debtors. Under the Jackson-Kronman analysis, such a potential undermines the very basis for secured credit generally.²⁸⁵

Thus, the full cross-collateralization of Variant B of Paradigm 3 cannot be permitted if the effect is to transfer purchase money priority to the purchase money creditor with respect to inventory he did not enable the debtor to ac-

282. See *supra* notes 219-31 and accompanying text.

283. See *supra* notes 219, 232-35.

284. See 2 J. WHITE & R. SUMMERS, *supra* note 62, at 511; McLaughlin, "Add On" Clauses, *supra* note 247, at 693-94; Lloyd, *supra* note 8 at 70-86; Stilson, *The "Overloaded" PMSI in Bankruptcy: A Problem in Search of a Resolution*, 60 TEMP. L.Q. 1, 4, 33-37 (1987); Note, *Preserving Purchase Money Security Interests and Allocating Payments*, 20 J.L. REFORM 849, 850, 861-63 (1987); Note, *Preserving the Purchase Money Status of Refinanced or Commingled Purchase Money Debt*, 35 STAN. L. REV. 1133, 1180 (1983).

285. See *supra* notes 148-54 and accompanying text.

quire. At a minimum, Felonious must be required to keep separate records of advances which, at their inception, fall into the purchase money category and advances which do not, and Felonious or Curly must keep track of which items were purchased with Felonious funds and which were not. Once those separate categories are created, there must be some mechanism for allocating payments; if Curly makes a 30,000 dollar payment, there must be some way (*e.g.*, a contractual allocation formula or a judicially or legislatively adopted tracing rule) to decide which debt is reduced or eliminated and, if the latter, which collateral (if any) is released. Within each category, there can be little objection to limited cross-collateralization, but the categories must be kept distinct.

Thus, if the purchase money inventory financier is prepared to be a specialist, like Felicitous of Paradigm 2 or like Felonious in Variant A of Paradigm 3, limited cross-collateralization is compatible with purchase money status as a matter of Code interpretation and policy. There are, however, reasons not to allow a fully cross-collateralized lender to upgrade the priority of his interest in nonpurchase money collateral under Variant B of Paradigm 3. But those reasons are reasons of policy, not logical entailments of the use of the phrase "its price" in U.C.C. section 9-107(a).

C. *Official Comment 2 and "Antecedent Debt"*

1. *The Basic Argument*

In controversies in which one party asserts that a secured creditor has somehow forfeited purchase money status, there is only one other argument that recurs with the frequency of the argument based on the "its price" language of U.C.C. section 9-107(a). The second argument relies on the text of Official Comment 2 to section 9-107, which provides as follows:

When a purchase money interest is claimed by a secured party who is not a seller, he must of course have given present consideration. This section therefore provides that the purchase money party must be one who gives value "by making advances or incurring an obligation": the quoted language excludes from the purchase money category any security interest taken as security for or in satisfaction of a preexisting claim or antecedent debt.

The specific focus of the argument in question is the "preexisting claim or antecedent debt" language of the final sentence. Its most common use has been in attempts to deny purchase money status to refinanced or consolidated debt and a security interest taken at the time of refinancing or consolidation.²⁸⁶

286. See *Billings v. Avco Colorado Industrial Bank*, (*In re Billings*), 838 F.2d 405 (10th Cir. 1988); *Dominion Bank of Cumberland Islands, NA v. Nuckolls*, 780 F.2d 408 (4th Cir. 1985); *Transamerica Fin. Servs. v. Matthews* (*In re Matthews*), 724 F.2d 798 (9th Cir. 1984); *Rosen v. Associates Fin. Servs. Co.*, 17 Bankr. 436 (D.S.C. 1982); *Matter of Ward*, 14 Bankr. 549 (S.D. Ga. 1981); *In re Hatfield*, 117 Bankr. 387 (Bankr. C.D. Ill. 1990); *Gillie v. First State Bank of Morton* (*In re Gillie*), 96 Bankr. 689 (Bankr. N.D. Tex. 1989); *In re Bowen*, 87 Bankr. 70 (Bankr. E.D. Mo. 1988); *Hipps v. Landmark Fin. Servs. of Ga., Inc.* (*In re Hipps*), 89 Bankr. 264 (Bankr. N.D. Ga. 1988); *In re Snipes*, 86 Bankr. 1006 (Bankr. W.D. Mo. 1988); *In re Wandler*, 77 Bankr. 735 (Bankr. D.N.D. 1987); *Franklin v. ITT Fin. Servs.* (*In re Franklin*), 75 Bankr. 268 (Bankr. M.D. Ga. 1986); *In re Faughn*, 69 Bankr. 18 (Bankr. E.D. Mo. 1986); *In re Mason*, 46 Bankr. 119 (Bankr. E.D. Mich. 1985); *Johnson v. Richardson* (*In re Richardson*), 47 Bankr. 113 (Bankr. W.D. Wis. 1985); *Russell v. Associates Fin. Servs. of Okla., Inc.* (*In re Russell*), 29 Bankr. 270 (Bankr. W.D. Okla. 1983); *Associates Fin. v. Conn* (*In re Conn*), 16

Though the "antecedent debt" argument is seldom articulated with great clarity, it can be summarized as follows. Official Comment 2 to U.C.C. section 9-107 denies purchase money status to any security interest granted and taken on account of, or in satisfaction of, a "preexisting claim" or "antecedent debt." A refinancing, however, typically involves the creation of a new security interest, sometimes in collateral which was also collateral under previous security interests and sometimes in additional collateral as well. The debt for which such a new security interest is taken, however, is either old debt or new debt which satisfies the old debt. It may be renewed or it may be consolidated, but it invariably pre-dates the security interest.²⁸⁷ It is thus either a "preexisting claim" or an "antecedent debt," and the security interest may not, therefore, be a purchase money security interest.²⁸⁸

Bankr. 454 (Bankr. W.D. Ky. 1982); *In re Hobdy*, 18 Bankr. 70 (Bankr. W.D. Ky. 1982); *Kelley v. United Am. Bank in Knoxville (In re Kelley)*, 17 Bankr. 770 (Bankr. E.D. Tenn. 1982); *King v. Citizens and Southern Nat. Bank (In re King)*, 19 Bankr. 409 (Bankr. M.D. Ga. 1982); *Credithrift of America v. Littlejohn (In re Littlejohn)*, 20 Bankr. 695 (Bankr. W.D. Ky. 1982); *In re Bechen*, 11 Bankr. 939 (Bankr. D.S.D. 1981); *Booker v. Commercial Credit Corp. (In re Booker)*, 9 Bankr. 710 (Bankr. M.D. Ga. 1981); *Johnson v. Citizens' Discount Loan and Savings Co. (In re Johnson)*, 15 Bankr. 681 (Bankr. W.D. Mo. 1981); *In re Lay*, 15 Bankr. 841 (Bankr. S.D. Ohio 1981); *Butterworth Furniture Co. v. Penny (In re Penny)*, 15 Bankr. 124 (Bankr. E.D. Va. 1981); *Coomer v. Barclays Am. Fin. Inc. (In re Coomer)*, 8 Bankr. 351 (Bankr. E.D. Tenn. 1980); *In re Jones*, 5 Bankr. 655 (Bankr. M.D.N.C. 1980); *Mulcahy v. Indianapolis Morris Plan Corp. (In re Mulcahy)*, 3 Bankr. 454 (Bankr. S.D. Ind. 1980); *Landaus of Plymouth Inc. v. Scott (In re Scott)*, 5 Bankr. 37 (Bankr. M.D. Pa. 1980); *Slay v. Pioneer Credit Co. (In re Slay)*, 8 Bankr. 355 (Bankr. E.D. Tenn. 1980); *Kawasho Int'l. (U.S.A.) Inc. v. Alpern (In re Mid-Atl. Flange Co. Inc.)*, 26 U.C.C. Rep. Serv. 203 (Bankr. E.D. Pa. 1979); *In re Simpson*, 4 U.C.C. Rep. Serv. 243 (Bankr. W.D. Mich. 1966); *In re Simpson*, 4 U.C.C. Rep. Serv., 250 (Bankr. W.D. Mich. 1966). See also *In re Ionosphere Clubs, Inc.*, 112 Bankr. 78 (Bankr. S.D.N.Y. 1990) (applying a similar argument in the context of commercial equipment financing).

287. If the premise that the debt is old is denied, the secured creditor's position is likewise jeopardized. If the refinanced debt is regarded as a new obligation (a "novation," as it is sometimes called in the cases), the secured creditor will have difficulty demonstrating that the obligation was incurred for the purpose of enabling the debtor to acquire rights in or use of the collateral and that it was in fact so used, as required by § 9-107(b). The argument that refinanced debt did not "enable" the purchase of the collateral is merely the flip side of the "antecedent debt" argument and occurs nearly as frequently. See *Dominion Bank of Cumberland, NA v. Nuckolls*, 780 F.2d 408, 413 (4th Cir. 1985); *Matthews v. TransAmerica Fin. Servs. (In re Matthews)*, 724 F.2d 798, 800 (9th Cir. 1984); *Matter of Ward*, 14 Bankr. 549, 552 (S.D. Ga. 1981); *In re Bowen*, 87 Bankr. 70 (Bankr. E.D. Mo. 1988); *Gillie v. First State Bank of Morton Texas (In re Gillie)*, 96 Bankr. 689, 692 (Bankr. N.D. Tex. 1989); *In re Snipes*, 86 Bankr. 1006, 1008 (Bankr. W.D. Mo. 1988); *In re Challinor*, 79 Bankr. 19, 22 (Bankr. D. Mont. 1987); *In re Wandler*, 77 Bankr. 735 (Bankr. D.N.D. 1987); *In re Faughn*, 69 Bankr. 18, 20 (Bankr. E.D. Mo. 1986); *Franklin v. ITT Fin. Servs. (In re Franklin)*, 75 Bankr. 268, 270 (Bankr. M.D. Ga. 1986); *In re Janz*, 67 Bankr. 553, 556 (Bankr. D.N.D. 1986); *In re Mason*, 46 Bankr. 119 (Bankr. E.D. Mich. 1985); *King v. Citizens and Southern Nat. Bank (In re King)*, 19 Bankr. 409, 411 (Bankr. M.D. Ga. 1982); *Fickey v. Bank of LaFayette (In re Fickey)*, 23 Bankr. 586 (Bankr. E.D. Tenn. 1982); *Booker v. Commercial Credit Corp. (In re Booker)*, 9 Bankr. 710, 712 (Bankr. M.D. Ga. 1981); *Matter of Johnson*, 15 Bankr. 681, 684 (Bankr. W.D. Mo. 1981); *Coomer v. Barclays Am. Fin. Inc. (In re Coomer)*, 8 Bankr. 351, 353 (Bankr. E.D. Tenn. 1980); *In re Jones*, 5 Bankr. 655, 656 (Bankr. M.D.N.C. 1980). But see *In re Hemingson*, 84 Bankr. 604 (Bankr. D. Minn. 1988) (dual status rule); *In re Geist*, 79 Bankr. 939 (D. Wyo. 1982) (same); *In re Fossum*, 59 Bankr. 820 (Bankr. D. Minn. 1986) (PMSI preserved where neither debt nor collateral added and debtor had made no payments).

288. The apparent origin of the "antecedent debt" argument is a bankruptcy decision, *In re Simpson*, 4 U.C.C. Rep. Serv. 243 (Bankr. W.D. Mich. 1966). In that case, a security agreement contained a future advance clause making the collateral secure ". . . the aforementioned indebtedness and . . . any other existing or future indebtedness not to exceed the sum of \$1200.00 . . ." *Id.* at 244. The original \$1,200.00 debt represented the purchase price of several items of farm equipment, and the Referee conceded that, but for the presence of the offensive clause, a purchase money security interest would have been created. *Id.* at 246. However, the debtor was, in fact, indebted to the original purchase money creditor from time to time on open account. *Id.* at 244. The Referee found it troublesome that it was possible for the collateral to secure not only its purchase price but future debt like the subsequent open account indebtedness. *Id.* at 246.

The overwhelming majority of the cases invoking the "antecedent debt" argument are bankruptcy cases in which the issue is whether the creditor's security interest is a purchase money security interest immune from attack under section 522(f) of the Bankruptcy Code.²⁸⁹ The fact patterns in such cases exhibit substantial variation. In most cases, the refinancing involves the consolidation of debts incurred at different times. The components of the consolidated debt may have all been initially purchase money advances or extensions of credit,²⁹⁰ or purchase money debt may be combined with nonpurchase money

At this point, it might have been natural for the Referee to conclude, in line with the argument of the preceding section, that because the collateral secured more than "its price," purchase money status was lost. The Referee apparently felt precluded from doing so, however, by the "to the extent" language of the opening clause of § 9-107. *See id.* at 247.

Instead he quoted the language of Official Comment 2 to the effect that a purchase money security interest may not secure a preexisting claim or antecedent debt. *Id.* at 246. He then reasoned that a security interest which captures future debt should be treated no differently from one which secures antecedent debt, and that in neither case should the security interest qualify as a purchase money security interest. The "antecedent debt" language of Official Comment 2 was thus used as an indirect way of attacking a future advance clause, and the result in *Simpson* was at least the verbal adoption of the transformation rule in its most extreme form; the mere use of the "language in question" resulted in a loss of purchase money status. *In re Simpson*, 4 U.C.C. Rep. Serv. at 248.

It is interesting, given the Referee's finding that the debtor was "usually indebted" to the purchase money creditor on open account, *id.* at 244, that the Referee did not consider the possibility that the debtor might have been already indebted on open account to the original purchase money creditor at the time of the original purchase money transaction. If so, the prior open account indebtedness would apparently have been within the reach of the future advance clause, which covered "any other existing or future indebtedness." This, in turn, would mean that the question whether the security interest embraced antecedent debt in contravention of Official Comment 2 would have been presented directly. Indeed, the same Referee, in an opinion in the same bankruptcy case issued less than two weeks later, used this more direct approach to deny purchase money status when a different secured creditor used a cross-collateralization clause to capture prior nonpurchase money indebtedness in what purported to be a purchase money security interest. *See In re Simpson*, 4 U.C.C. Rep. Serv. at 254. Instead, however, the Referee, in the first opinion, only used Official Comment 2 by way of analogy to prohibit the securing of future debt with a purchase money security interest.

289. Section 522(f) allows the debtor to avoid a nonpossessory nonpurchase money security interest in property which, absent the security interest, would be exempt. *See* 11 U.S.C. § 522(f). All of the cases cited in *supra* note 285, involved § 522(f) except *In re Ionosphere Clubs, Inc.*, 112 Bankr. 78 (Bankr. S.D.N.Y. 1990) (commercial equipment financing); *Butterworth Furniture Co. v. Penny (In re Penny)*, 15 Bankr. 124 (Bankr. E.D. Va. 1981) (motions by creditor to recover personal property and for relief from automatic stay); *Kawasho Int'l (U.S.A.) Inc. v. Alper (In re Mid-Atl. Flange Co., Inc.)*, 26 U.C.C. Rep. Serv. 203 (Bankr. E.D. Pa. 1979) (creditor's suit for reclamation); and the two decisions in *In re Simpson*, 4 U.C.C. Rep. Serv. 243 and 250 (Bankr. W.D. Mich. 1966) (both petitions by Trustee to set aside liens).

290. *See Billings v. Avco Colorado Industrial Bank (In re Billings)*, 838 F.2d 405 (10th Cir. 1988) (refinancing of single purchase money transaction; court adopts dual status rule); *In re Hatfield*, 117 Bankr. 387 (Bankr. C.D. Ill. 1990) (refinancing of purchase money debt without new advance or new collateral; PMSI sustained on theory that transaction was mere renewal, not novation); *In re Bowen*, 87 Bankr. 70 (Bankr. E.D. Mo. 1988) (purchase money debt refinanced twice without addition of collateral or debt other than interest and refinancing fees; PMSI extinguished); *Gillie v. First State Bank of Morton Texas (In re Gillie)*, 96 Bankr. 689 (Bankr. N.D. Tex. 1989) (refinancing of single purchase money debt; PMSI lost); *In re Faughn*, 69 Bankr. 18 (Bankr. E.D. Mo. 1986) (consolidation of 3 purchase money transactions; PMSI in all but collateral purchased in last transaction lost); *Fickey v. Bank of Lafayette (In re Fickey)*, 23 Bankr. 586 (Bankr. E.D. Tenn. 1982) (refinancing of single conditional sale contract with apparent addition of refinancing charge; PMSI lost in absence of reallocation formula); *Schewel Furniture Co. v. Goard (In re Goard)*, 26 Bankr. 316 (Bankr. M.D.N.C. 1982) (series of purchase money security agreements, last of which consolidated entire debt; PMSI retained where state statute provided for pro rata allocation of repayments); *In re Hobdy*, 18 Bankr. 70 (Bankr. W.D. Ky. 1982) (consolidation of purchase money transactions; PMSI in last items of collateral preserved where no payments had been made and final agreement allocated debt); *Creditthrift of America v. Littlejohn (In re Littlejohn)*, 20 Bankr. 695 (Bankr. W.D. Ky. 1982) (renewal of single purchase money debt does not result in loss of PMSI); *Butterworth Furniture Co. v. Penny (In re Penny)*, 15 Bankr. 124 (Bankr. E.D. Va. 1981) (PMSI lost); *In re Lay*, 15 Bankr. 841 (Bankr. S.D. Ohio 1981) (consolidated purchase money debts; PMSI lost in first item of collateral); *Mulcahy*

advances or credit extensions, or other charges.²⁹¹ In some cases, new cash advances are made to the debtor at the time of the refinancing.²⁹² Similarly, on the collateral side of the transaction, the collateral for the refinanced debt may consist entirely of what was initially purchase money collateral,²⁹³ or a mixture of purchase money collateral and nonpurchase money collateral.²⁹⁴ The reported

v. Indianapolis Morris Plan Corp. (*In re Mulcahy*), 3 Bankr. 454 (Bankr. S.D. Ind. 1980) (consolidation of 2 purchase money debts; PMSI in first collateral lost); *Landaus of Plymouth, Inc. v. Scott* (*In re Scott*), 5 Bankr. 37 (Bankr. M.D. Pa. 1980) (consolidation of several purchase money debts; PMSI lost).

291. See *In re Johnson*, 101 Bankr. 280 (Bankr. W.D. Okla. 1989) (dual status rule applied, relying on earlier cases); *In re Hemmingson*, 84 Bankr. 604 (Bankr. D. Minn. 1988) (dual status rule); *Hipps v. Landmark Fin. Servs. of Ga., Inc.* (*In re Hipps*), 89 Bankr. 264 (Bankr. N.D. Ga. 1988) (PMSI lost); *In re Snipes*, 86 Bankr. 1006 (Bankr. W.D. Mo. 1988) (PMSI lost); *In re Wandler*, 77 Bankr. 735 (Bankr. D.N.D. 1987) (PMSI lost); *Franklin v. ITT Fin. Servs.* (*In re Franklin*), 75 Bankr. 268 (Bankr. M.D. Ga. 1986) (PMSI lost); *In re Yokley*, 42 Bankr. 575 (Bankr. N.D. Ala. 1984) (PMSI lost; no discussion of reasons); *In re Calloway*, 17 Bankr. 212 (Bankr. W.D. Ky. 1982) (PMSI lost; novation theory); *Kelley v. United Am. Bank in Knoxville* (*In re Kelley*), 17 Bankr. 770 (Bankr. E.D. Tenn. 1982) (PMSI lost); *King v. Citizens and Southern Nat. Bank* (*In re King*), 19 Bankr. 409 (Bankr. M.D. Ga. 1982) (PMSI lost); *Bechen v. Livestock State Bank, Artesian, South Dakota* (*In re Bechen*), 11 Bankr. 939 (Bankr. D.S.D. 1981) (PMSI lost).

292. See *Billings v. Avco Colorado Industrial Bank* (*In re Billings*), 838 F.2d 405 (10th Cir. 1988) (new advance \$9.67; court adopts dual status rule); *Dominion Bank of Cumberland, NA v. Nuckolls*, 780 F.2d 408 (4th Cir. 1985) (PMSI lost); *Rosen v. Fin. Servs. Co.*, 17 Bankr. 436 (D.S.C. 1982) (PMSI lost); *Matter of Ward*, 14 Bankr. 549 (S.D. Ga. 1981) (PMSI lost); *In re Johnson*, 101 Bankr. 280 (Bankr. W.D. Okla. 1989) (dual status rule applied, relying on earlier cases); *In re Snipes*, 86 Bankr. 1006 (Bankr. W.D. Mo. 1988) (PMSI lost); *Franklin v. ITT Fin. Servs.* (*In re Franklin*), 75 Bankr. 268 (Bankr. M.D. Ga. 1986) (small cash advance, additional debt increase for loan fees, insurance charges, and prepaid finance charge; PMSI lost); *In re Mason*, 46 Bankr. 119 (Bankr. E.D. Mich. 1985) (PMSI lost in absence of legislative or contractual payment allocation formula); *Schneider v. Fidelity Nat. Bank* (*In re Schneider*), 37 Bankr. 747 (Bankr. N.D. Ga. 1984) (PMSI lost; novation theory); *Russell v. Associates Fin. Servs. of Okla., Inc.* (*In re Russell*), 29 Bankr. 270 (Bankr. W.D. Okla. 1983) (dual status rule); *In re Calloway*, 17 Bankr. 212 (Bankr. W.D. Ky. 1982) (PMSI lost; novation theory); *Associates Fin. v. Conn* (*In re Conn*), 16 Bankr. 454 (Bankr. W.D. Ky. 1982) (dual status rule, FIFO payment allocation); *In re Jones*, 5 Bankr. 655 (Bankr. M.D.N.C. 1980) (PMSI lost); *Slay v. Pioneer Credit Co.* (*In re Slay*), 8 Bankr. 355 (Bankr. E.D. Tenn. 1980) (court expresses approval of transformation rule generally but applies dual status rule where lack of payments by debtor makes determination of extent of PMSI possible).

293. See cases cited *supra* at note 290.

294. See *Dominion Bank of Cumberland, NA v. Nuckolls*, 780 F.2d 408 (4th Cir. 1985) (refinancing provided additional cash to debtors and added collateral; PMSI lost even though debtors had made no repayments); *Matthews v. TransAmerica Fin. Servs.* (*In re Matthews*), 724 F.2d 798 (9th Cir. 1984) (although both purchase money collateral and other household goods secured loan at inception, PMSI created; however, PMSI lost on refinancing); *Matter of Ward*, 14 Bankr. 549 (S.D. Ga. 1981) (household goods taken as additional security at time of refinancing; PMSI lost); *Hipps v. Landmark Fin. Servs. of Ga., Inc.* (*In re Hipps*), 89 Bankr. 264 (Bankr. N.D. Ga. 1988) (consolidation of purchase money debt with other debt and addition of nonpurchase money collateral; PMSI lost under transformation rule); *In re Snipes*, 86 Bankr. 1006 (Bankr. W.D. Mo. 1988) (purchase money debt consolidated with new loan and additional collateral taken; PMSI lost under transformation rule); *In re Walker*, 77 Bankr. 735 (Bankr. D.N.D. 1987) (purchase money loan combined with other loans and additional collateral taken; PMSI lost); *Franklin v. ITT Fin. Servs.* (*In re Franklin*), 75 Bankr. 268 (Bankr. M.D. Ga. 1986) (purchase money loan refinanced, increasing size of debt adding nonpurchase money collateral; PMSI lost); *In re Mason*, 46 Bankr. 119 (Bankr. E.D. Mich. 1985) (refinancing of purchase money debt including new cash advance and addition of nonpurchase money collateral; PMSI lost in absence of statutory or contractual payment allocation formula); *In re Richardson*, 47 Bankr. 113 (Bankr. W.D. Wis. 1985) (where new party advances funds to pay off original purchase money loan, new party does not hold PMSI); *Schneider v. Fidelity Nat. Bank* (*In re Schneider*), 37 Bankr. 747 (Bankr. N.D. Ga. 1984) (refinancing increased size of debt and added nonpurchase money collateral; held to be a novation, destroying PMSI); *In re Calloway*, 17 Bankr. 212 (Bankr. W.D. Ky. 1982) (series of refinancing transactions involving new cash advances and addition of nonpurchase money collateral; PMSI lost on theory that each refinancing is a novation); *Associates Fin. v. Conn* (*In re Conn*), 16 Bankr. 454 (Bankr. W.D. Ky. 1982) (refinancing includes new cash advance and addition of nonpurchase money collateral; court applies dual status rule and determines the extent of PMSI by judicially-adopted FIFO payment allocation principle); *Russell v. Associates Fin. Servs. of Okla., Inc.* (*In re Russell*), 29 Bankr. 270 (Bankr. W.D. Okla. 1983) (refinancing includes new cash advance and addition of nonpurchase money collateral; court applies

decisions form the same patchwork of transaction rule cases and dual status rule cases observed in connection with the "its price" argument.²⁹⁵

2. Criticism

The refinancing cases have been criticized at length by commentators. The predominant view of the critics seems to be that something like the "dual status" rule should apply; that is, if the debt and security interest refinanced is, in whole or in part, purchase money in character, then the refinanced debt and security interest should likewise be purchase money "to the extent" that contractual, judicial, or legislative tracing rules can be used to separate purchase money from nonpurchase money debt and collateral.²⁹⁶

Little more would need to be said about the "antecedent debt" argument if it could be confined to refinancing transactions. There are, however, suggestions by some commentators that cross-collateralization clauses, even those of the limited variety found in Paradigm 2, are vulnerable to the same attack.²⁹⁷ Thus, it might be argued, the operation of the after-acquired property aspect of a cross-collateralization clause is the attachment of a security interest for antecedent debt, since any newly-acquired property secures not only the debt which enabled its acquisition but any outstanding balance on previous advances (which may be purchase money under Paradigm 2 and Variant A of Paradigm 3 but not Variant B of Paradigm 3). Indeed, it is possible to read *Southtrust*, as having implicitly (and extremely cryptically) adopted the "antecedent debt" rationale.²⁹⁸

There are, nevertheless, three reasons why the "antecedent debt" language of Official Comment 2 to U.C.C. section 9-107 should not be read to preclude limited cross-collateralization arrangements. First, the final sentence of Official

dual status rule and determines extent of PMSI by using FIFO payment allocation principle); *King v. Citizens and Southern Nat. Bank (In re King)*, 19 Bankr. 409 (Bankr. M.D. Ga. 1982) (series of refinancings combining purchase money and nonpurchase money debt and collateral; PMSI lost); *Booker v. Commercial Credit Corp. (In re Booker)*, 9 Bankr. 710 (Bankr. M.D. Ga. 1981) (security agreement executed at time of purchase money advance consolidates debt and collateral from previous security agreement which is not identified as either purchase money or nonpurchase money; PMSI lost under transformation rule); *Coomer v. Barclays Am. Fin. Inc. (In re Coomer)*, 8 Bankr. 351 (Bankr. E.D. Tenn. 1980) (purchase money loan consolidated with earlier nonpurchase money loan and nonpurchase money collateral; in absence of legislative or contractual payment allocation rule, PMSI lost); *In re Simpson*, 4 U.C.C. Rep. Serv. 250 (Bankr. W.D. Mich. 1966) (initial nonpurchase money debt and collateral included in second security agreement at time of purchase money advance; PMSI lost).

295. See cases cited in *supra* notes 290-94.

296. See authorities cited *supra* at note 284.

297. See, e.g., Stilson, *The "Overloaded" PMSI in Bankruptcy: A Problem in Search of a Resolution*, 60 TEMP. L.Q. 1 (1987) (generally including cross-collateralization, along with refinancing or consolidation transactions, as a form of "overloading"); Note, *Preserving Purchase Money Security Interests and Allocating Payments*, 20 J.L. REFORM 849, 861 (1987) (suggesting any use of future advance or after-acquired property clauses triggers Official Comment 2 to § 9-107).

298. See *Southtrust*, 760 F.2d at 1243. Indeed, the court in *Ionosphere*, 112 Bankr. at 83-84, explicitly relied on the "antecedent debt" rationale in denying purchase money status to a purported purchase money equipment security interest in aircraft. It is not clear, however, whether the court embraced the thesis that prior purchase money advances under a limited cross-collateralization arrangement constitutes antecedent debt or whether the court merely held that attempts to bootstrap prior nonpurchase money advances to the status of purchase money debt must be rejected. The former thesis is mistaken for reasons elaborated at *infra* notes 299-303 and accompanying text. The latter is unobjectionable, for reasons parallel to those elaborated in *supra* Part III.B.9., but it is of questionable relevance to the facts of *Ionosphere*.

Comment 2, which contains the exclusion from purchase money status of those security interests taken for a preexisting claim or antecedent debt, should be interpreted in light of the first sentence of Official Comment 2. The first sentence indicates that the requirements of section 9-107(b) are satisfied by a secured creditor who provides "present consideration." While "present consideration" in the form of a new advance or a new obligation may not always be given by the secured creditor in a *refinancing* transaction, under the Larry/Felicitous agreement of Paradigm 2 any newly-acquired widgets must have been purchased with a fresh Felicitous advance in order to meet the definition of "collateral" and so come within the reach of the after-acquired property clause of the cross-collateralization provision.²⁹⁹ Official Comment 2 does not literally require anything more than such a contemporaneous advance or obligation.³⁰⁰

Second, Official Comment 2 must, in all events, be regarded as qualified by U.C.C. section 9-108.³⁰¹ U.C.C. section 9-108 prevents an interest arising under an after-acquired property clause from being considered an interest taken for antecedent debt if the secured creditor gives new value at the inception of the credit relationship and if the new collateral is either acquired in the ordinary course of the debtor's business or under a purchase contract contemplated by the security agreement and consummated within a reasonable time. Normally, the inventory of a wholesale or retail dealer of goods will be acquired in the ordinary course of the debtor's business; acquiring and selling inventory is the very nature of such a business. As nothing in U.C.C. section 9-108 or its Official Comments precludes its application to otherwise permissible cross-collateralized purchase money financing, it would save most arrangements corresponding to Paradigm 2 or Variant A of Paradigm 3.

Third, the status of Official Comment 2 is somewhat dubious in light of other interpretive difficulties it creates.³⁰² Under the text of U.C.C. section 9-107(b), qualification for purchase money status requires that the secured creditor give value for the purpose of enabling the debtor to acquire rights in the collateral and that the value given actually be used by the debtor in that fashion. This would seem to validate advances made either before, or contemporaneous with, the debtor's acquisition of rights in the collateral. If Official Comment 2's reference to "antecedent debt" and "preexisting claims" is interpreted on a strict temporal basis, however, it would seem that only contemporaneous ad-

299. The same is true, though by accident not by contract, of the *de facto* equivalent of Paradigm 2 found in Variant A of Paradigm 3.

300. In particular, Official Comment 2 need not be read so that the newly-acquired collateral may secure nothing but the contemporaneous advance, on the theory that securing anything else taints the transaction with "antecedent debt." Such a theory would simply be a reformulation of the "its price" argument disposed of in Part III.B.

301. U.C.C. § 9-108 provides as follows:

Where a secured party makes an advance, incurs an obligation, releases a perfected security interest, or otherwise gives new value which is to be secured in whole or in part by after-acquired property his security interest in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral either in the ordinary course of his business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given.

302. For a more complete statement of the problem summarized in the text, see McLaughlin, "Purchase Money", *supra* note 247 at 227-30.

vances would suffice. Any gap between the secured creditor's advance and the debtor's acquisition of rights would make the "claim" or "debt" of the secured creditor "preexisting" or "antecedent." As the text of section 9-107(b) must prevail over the Official Comments, and as the first sentence of Official Comment 2 can be read to qualify the second, it is best to reject such a strict temporal reading of the second sentence of Official Comment 2. Both Official Comment 2 and section 9-107(b) should be read as an attempt simply to confine purchase money status to *enabling* debt and the corresponding security interest.³⁰³ Accordingly, both the "its price" and "antecedent debt" arguments fail. Therefore there is no *textual* barrier to permitting limited cross-collateralization arrangements, and, as noted above, the justifications for purchase money priority actually support such arrangements.

D. Consumer and Commercial Contexts

In the course of denying purchase money status to a limited cross-collateralization arrangement for purchase money inventory financing, the *Southtrust* court specifically rejected the inventory financier's argument that the transformation rule had been developed in the context of consumer bankruptcies and therefore should not be applied uncritically in the commercial context.³⁰⁴ The court's primary basis for rejecting the argument was the fact that the drafters

303. See *Kawasho Int'l (U.S.A.), Inc. v. Alper (In re Mid-Atlantic Flange Co., Inc.)*, 26 U.C.C. Rep. Serv. 203, 208-09 (Bankr. E.D. Pa. 1979); B. CLARK, *THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE*, ¶ 3.09[2][a] (2d ed. 1988) (arguing in favor of a "direct nexus" rule); 2 G. GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY*, § 29.2, at 782 (1965) (advocating PMSI status if loan and purchase transaction are "closely allied.").

304. See *Southtrust*, 760 F.2d at 1242.

Judicial insensitivity to the distinction between commercial and consumer transactions was taken to new (and bizarre) heights in *In re Ionosphere Clubs, Inc.*, 112 Bankr. 78 (Bankr. S.D.N.Y. 1990). In that case, the Chapter 11 debtor in possession (Eastern Air Lines sought a declaration that a security interest held by a consortium of foreign banks (collectively called the "Airbus Lenders") did not have purchase money status and so was not entitled to the special protection accorded purchase money equipment security interests by 11 U.S.C. § 1110. The obligations secured were represented by a series of notes, all of which apparently were given at the time of advances which enabled Eastern to purchase aircraft and aircraft parts. The obligations were secured by a "Floating Collateral Pool" created by a Trust Indenture. The Floating Collateral Pool included the aircraft and parts purchased with Airbus Lenders' advances, as well as other aircraft and parts. Under the terms of the Indenture, the Floating Collateral Pool secured the obligations of all the Notes to the Airbus Lenders, as well as Notes to other, nonpurchase money lenders. The Indenture specifically provided that the Floating Collateral Pool secured all Notes equally and ratably.

Though the case depended on a construction of the form "purchase money equipment security interest" ("PMESI") in 11 U.S.C. § 1110, the court applied U.C.C. § 9-107 as a matter of federal common law.

The court adopted the "its price" argument (discussed *supra* at notes 242-46 and accompanying text), relying without hesitation, on the consumer bankruptcy cases *In re Norrell*, 426 F. Supp. 435 (M.D. Ga. 1977) and *In re Manuel*, 507 F.2d 990 (5th Cir. 1975) (both discussed at *supra* notes 206-18 and accompanying text). The court likewise adopted the "antecedent debt" argument relying only on the Official Comment to U.C.C. § 9-107. The Airbus Lenders responded with an attempt to invoke the "dual status" rule, discussed at *supra* notes 220-32 and accompanying text. Apparently there was no difficulty in identifying which aircraft were purchased with each of the Airbus Lenders' advances, and Airbus Lenders sought nothing more than such purchase money collateral. Further, Airbus Lenders offered to provide an allocation scheme to help the court determine how much of the balance on each Note remained unpaid, so that purchase money debt and collateral could have been correlated. In spite of its earlier reliance on consumer cases adopting the transformation rule, however, the court suggested that the dual status rule should be confined to cases involving consumer goods. With a few citations to *Southtrust* thrown in for good measure, the court held that the security interest of Airbus Lenders lacked purchase money status.

of Article 9 gave no express directive in U.C.C. sections 9-107 or 9-312(3) to make such distinctions.³⁰⁵ In other cases, language used by courts considering cross-collateralization provisions of one kind or another reflect a more overt consumer-oriented suspicion of such arrangements.³⁰⁶

It is, of course, perfectly true that U.C.C. sections 9-107 and 9-312(3) do not expressly distinguish consumer from commercial transactions, and that the Code does contain some specific provisions for the protection of consumers, such as the limitation of the effectiveness of the after-acquired property clause with respect to consumer goods.³⁰⁷ Nevertheless, it would be a mistake to read Article 9 as one grand consumer protection statute, incorporating all the consumer-oriented policies of current regulatory legislation. Indeed, both in the Official Comment to U.C.C. section 9-101 and the Note accompanying U.C.C. section 9-102, the drafters specifically disclaim any intent to address the special problems or abuses of consumer installment sales and consumer loans. An early draft of Article 9 had included several provisions concerning consumer transactions, including one restricting the use of the "add-on" cross-collateralization clause;³⁰⁸ but the separate consumer provisions were deleted due to an inability to reach consensus on them.³⁰⁹ At least some of the disputants apparently felt the consumer provisions were unfairly restrictive of the activities of consumer lenders.³¹⁰ The degree to which Article 9 should be regarded as consumer-oriented is thus ambiguous at best.

The same is not true of the battleground upon which, in recent years, the contest between the transformation rule and the dual status rule has taken place. By far the majority of such cases have been bankruptcy cases involving the refinancing of consumer debt, and the typical procedural posture in which

The *Southtrust* case, the "its price" argument, and the "antecedent debt" argument have all been criticized at length at *supra* notes 250-54, 296-303, and accompanying text. Nevertheless, it may be that the court in *Ionosphere* reached the correct result, albeit for the wrong reason. The court was quite appropriately concerned by the fact that the Trust Indenture (which was cross-referenced in the Airbus Lenders' security agreements with Eastern) made a collateral pool (including both the aircraft purchased with Airbus Lenders' funds and other aircraft) stand as security *equally and ratably* with other lenders who did not claim and did not have purchase money security interests. While the court appears to have drawn only the erroneous conclusion that Airbus Lenders was trying to bootstrap its interest in nonpurchase money collateral to a position of purchase money priority, the "equal and ratable" provision could easily have yielded a more appropriate conclusion. Specifically, the court could have concluded that the Trust Indenture and the Airbus Lenders' security agreements, taken together, amounted to a subordination agreement under U.C.C. § 9-316 and that the subordination agreement effectively deprived the security interest of the Airbus Lenders of the purchase money status that it otherwise would have enjoyed.

305. *Southtrust*, 760 F.2d at 1242.

306. Perhaps the best example is *In re Simpson*, 4 U.C.C. Rep. Serv. 243, 248 (Bankr. W.D. Mich. 1966), in which the Referee cautioned secured creditors not to "burden" a purchase money security interest with "complicated and ambiguous impedimenta" or engage in drafting "antics" reminiscent of those of the "adroit drafters" of conditional sale contracts. Cf. B. CLARK, *supra* note 70, ¶ 10.01[3][b] at 10-14 (predicting that courts inclined to strike down a future advance clause will characterize it as a "dragnet," "octopus," "anaconda," "boa constrictor," or "venus flytrap").

307. U.C.C. § 9-204(2).

308. See G. GILMORE, *supra* note 17, § 9.2 at 293 n.8. Ironically, when the National Conference of Commissioners on Uniform State Laws did draft a consumer protection statute, the Uniform Consumer Credit Code, they chose to authorize cross-collateralization in consumer transactions expressly, subject to a first in, first out application of payments rule. See Uniform Consumer Credit Code §§ 3.302 and 3.303.

309. See G. GILMORE, *supra* note 17, § 9.2 at 293-94.

310. See *id.*

the issue is decided is an attempt by the debtor in bankruptcy to avoid the lien of his secured creditor under 11 U.S.C. section 522(f) on the grounds that it is a "nonpossessory nonpurchase-money security interest" in exempt property in one of the classes enumerated in the statute.³¹¹

In contrast to the U.C.C., section 522(f) of the Bankruptcy Code has a clear consumer-oriented purpose and history. Aside from the general concern for the debtor's "fresh start,"³¹² the major purpose of 11 U.S.C. section 522(f) was to address a set of practices by consumer lenders and retail installment sellers which Congress considered abusive. Specifically, there was testimony before Congress that certain consumer lenders and sellers had a practice, even in relatively small transactions, of taking virtually all the debtor's household goods as collateral. Such goods are of little value on foreclosure, and thus provide little real security for the creditor. However, the threat of foreclosure is an effective way of coercing payments, since replacement costs of such goods are high and deprivation of household goods is extremely disruptive to the life of the debtor. The use of household goods (whether financed by the creditor or not) as collateral thus served more as a bludgeon than a security device.³¹³ Congress'

311. See *Billings v. Avco Colorado Industrial Bank (In re Billings)*, 838 F.2d 405 (10th Cir. 1988); *Pristas v. Landaus of Plymouth, Inc. (In re Pristas)*, 742 F.2d 797 (3rd Cir. 1984); *Matthews v. TransAmerica Fin. Servs. (In re Matthews)*, 724 F.2d 798 (9th Cir. 1984); *Greenville, Inc. v. McCall (In re McCall)*, 62 Bankr. 57 (M.D. Ala. 1988); *Matter of Ward*, 14 Bankr. 549 (S.D. Ga. 1981); *Gillie v. First State Bank of Morton Texas (In re Gillie)*, 96 Bankr. 689 (Bankr. N.D. Tex. 1989); *In re Bowen*, 87 Bankr. 70 (Bankr. E.D. Mo. 1988); *Hipps v. Landmark Fin. Servs. of Ga., Inc. (In re Hipps)*, 89 Bankr. 264 (Bankr. N.D. Ga. 1988); *In re Snipes*, 86 Bankr. 1006 (Bankr. W.D. Mo. 1988); *In re Harrell*, 72 Bankr. 107 (Bankr. N.D. Ala. 1987); *In re Faughn*, 69 Bankr. 18 (Bankr. E.D. Mo. 1986); *Franklin v. ITT Fin. Servs. (In re Franklin)*, 75 Bankr. 268 (Bankr. M.D. Ga. 1986); *Bond's Jewelers, Inc. v. Linklater (In re Linklater)*, 48 Bankr. 916 (Bankr. D. Nev. 1985); *In re Mason*, 46 Bankr. 119 (Bankr. S.D. Mich. 1985); *Johnson v. Richardson (In re Richardson)*, 47 Bankr. 113 (Bankr. W.D. Wis. 1985); *In re Schwartz*, 52 Bankr. 314 (Bankr. E.D. Pa. 1985); *In re Yokley*, 42 Bankr. 574 (Bankr. N.D. Ala. 1984); *Breakiron v. Montgomery Ward (In re Breakiron)*, 32 Bankr. 400 (Bankr. W.D. Pa. 1983); *Gayhart v. Beneficial Fin. Co. of Illinois, Inc. (In re Gayhart)*, 33 Bankr. 699 (Bankr. E.D. Ill. 1983); *Keller v. Household Finance Corp. Retail Services (In re Keller)*, 29 Bankr. 91 (Bankr. M.D. Fla. 1983); *Russell v. Associates Fin. Servs. of Okla., Inc. (In re Russell)*, 29 Bankr. 270 (Bankr. W.D. Okla. 1983); *In re Calloway*, 17 Bankr. 212 (Bankr. W.D. Ky. 1982); *Associates Fin. v. Conn (In re Conn)*, 16 Bankr. 454 (Bankr. W.D. Ky. 1982); *Fickey v. Bank of LaFayette (In re Fickey)*, 23 Bankr. 586 (Bankr. E.D. Tenn. 1982); *In re Georgia*, 22 Bankr. 31 (Bankr. S.D. Ohio 1982); *Haus v. Barclays American Corp. (In re Haus)*, 18 Bankr. 413 (Bankr. D.S.C. 1982); *In re Hobdy*, 18 Bankr. 70 (Bankr. W.D. Ky. 1982); *Kelley v. United Am. Bank of Knoxville (In re Kelley)*, 17 Bankr. 770 (Bankr. E.D. Tenn. 1982); *King v. Citizens and Southern Nat. Bank (In re King)*, 19 Bankr. 409 (Bankr. M.D. Ga. 1982); *Credithrift of America v. Littlejohn (In re Littlejohn)*, 20 Bankr. 695 (Bankr. W.D. Ky. 1982); *In re Luczak*, 16 Bankr. 743 (Bankr. W.D. Wis. 1982); *Snyder v. Fidelity Nat. Bank (In re Snyder)*, 16 Bankr. 381 (Bankr. S.D. Ohio 1982); *Bechen v. Livestock State Bank, Artesian, South Dakota (In re Bechen)*, 11 Bankr. 939 (Bankr. D.S.D. 1982); *Booker v. Commercial Credit Corp. (In re Booker)*, 9 Bankr. 710 (Bankr. M.D. Ga. 1981); *In re Gibson*, 16 Bankr. 257 (Bankr. D. Kan. 1981); *Meadows v. Household Retail Servs. (In re Griffin)*, 9 Bankr. 880 (Bankr. N.D. Ga. 1981); *Matter of Johnson*, 15 Bankr. 681 (Bankr. W.D. Mo. 1981); *In re Lay*, 15 Bankr. 84 (Bankr. S.D. Ohio 1981); *Coomer v. Barclays Am. Fin. Inc. (In re Coomer)*, 8 Bankr. 351 (Bankr. E.D. Tenn. 1980); *In re Jones*, 5 Bankr. 655 (Bankr. M.D.N.C. 1980); *McLemore v. Simpson County Bank (In re Krulik)*, 6 Bankr. 443 (Bankr. M.D. Tenn. 1980); *Mulcahy v. Indianapolis Morris Plan Corp. (In re Mulcahy)*, 3 Bankr. 454 (Bankr. S.D. Ind. 1980); *Slay v. Pioneer Credit Co. (In re Slay)*, 8 Bankr. 355 (Bankr. E.D. Tenn. 1980).

312. See H. R. Rep. No. 595, 95th Cong. 1st Sess. 126, reprinted in 1978 U.S. Code Cong. and Admin. News 6087. See also Lloyd, *supra* note 8 at 82-83; Stilson, *supra* note 297, at 28, 35.

313. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 126-27, 169-72 (1977) reprinted in 1978 U.S. Code Cong. and Admin. News 6087-88, 6130-33; *Dominion Bank of the Cumberland, NA v. Nuckolls*, 780 F.2d 408 (4th Cir. 1985); *Matter of Ward*, 14 Bankr. 549 (Bankr. S.D. Ga. 1981); *In re Harrell*, 72 Bankr. 107 (Bankr. N.D. Ala. 1987); *Coomer v. Barclays Am. Fin. Inc. (In re Coomer)*, 8 Bankr. 351 (Bankr. E.D. Tenn. 1980). See also

response was to allow such security interests to be avoided by the debtor, unless they were possessory or purchase money in character.³¹⁴

Obviously, the consumer oppression to which 11 U.S.C. section 522(f) was a response is indefensible. It is probably neither possible nor productive to ascertain the degree to which a hostility to such tactics actually affected the decisions of the courts or colored the language of the opinions in the bankruptcy cases involving the transformation rule. It is important, however, that the inherent suspicion of consumer lenders or sellers reflected in such cases not be generalized to include purely commercial financing relationships in general or cross-collateralization agreements in the commercial context. Asset-based lenders seem to view the collateral taken under a security agreement as a genuine potential source of repayment in the event of default, as their loan evaluations typically include collateral examination and evaluation procedures in addition to cash flow analyses designed to assess the probability of repayment.³¹⁵ Where collateral is not commercially worthless, there is less reason to assume that it is taken solely for the purpose of making idle threats of its deprivation.³¹⁶ Moreover, there is some doubt that the disparity of bargaining power characteristic of consumer transactions carries over into the relationship between a commercial lender and a business entity.³¹⁷ Thus if, as suggested above, the use of

Billings v. Avco Colorado Industrial Bank (*In re Billings*), 838 F.2d 405 (10th Cir. 1988) (Congress sought in enacting § 522(f) to prevent creditor overreacting in the form of security interests in household goods already owned by debtor); *In re Hemingson*, 84 Bankr. 604 (Bankr. D. Minn. 1988) (§ 522(f) aimed at preventing creditor overreaching); *Russell v. Associates Fin. Servs. of Okla., Inc.* (*In re Russell*), 29 Bankr. 270 (Bankr. W.D. Okla. 1983) (§ 522(f) intended to reach creditor overreaching in form of blanket security interest in all of debtor's household goods); *In re Gibson*, 16 Bankr. 257 (Bankr. D. Kan. 1981) (§ 522(f) enacted to allow consumer debtor to avoid liens on used household goods); *Associates Fin. Servs. of Ind., Inc. v. Boldman*, 495 N.E.2d 203 (Ind. Ct. App. 1986). See also Lloyd, *supra* note 8 at 6-7, 54-56.

314. Indeed, the Federal Trade Commission Credit Practices Rules now make it an unfair credit practice for a lender or retail installment seller to take a nonpossessory security interest in household goods other than a purchase money security interest. See 16 C.F.R. § 444.2(a)(4).

315. The differences between conventional unsecured bank lending and asset-based lending and, in particular, the use of relative cash flow and collateral evaluation rather than balance sheet analysis are reflected in the practitioner and business-oriented literature. See, e.g., Weissman, *What You Need To Know About Asset-Based Lending*, VENTURE: PRIME + 12 (Oct. 1988); Iannuccilli, *Asset-Based Lending: An Overview*, J. COMMERCIAL BANK LENDING, 54, 55-56 (March 1988); Goldman, *Asset-Based Financing Finds Niche with Middle Market Firms*, CRAI'S NEW YORK BUSINESS 9 (June 16, 1986); Klier, *Asset Based Financing*, CPA JOURNAL 71 (May 1984); Sannella, *Asset-based Financing*, J. ACCOUNTANCY, 44, 45 (May 1983); Koe, *When Good Credits are Scarce, Look to Asset-Based Lending*, ABA BANKING J. 89 (March 1983); Miller, *MAS Consultant's Role in Asset-Based Financing*, CPA JOURNAL 24, 26 (April 1982); Logan, *Clearing Up the Confusion About Asset-Based Financing*, J. COMMERCIAL BANK LENDING 11, 12 (May 1982).

316. This is not to say that repossession and sale is the secured creditor's preferred option, or that secured creditors in the commercial setting do not use their collateral position to exert pressure on debtors to make payment. See, e.g., Diamond, *Asset-Based Lending in a Changing Environment*, J. COMMERCIAL BANK LENDING 42, 45 (May, 1981) (collateral should not be sole criterion for credit extension, and should never be sufficient without evidence of positive cash flow). However, Professor Scott has argued that the leverage over the debtor exercised by a secured creditor with a floating lien is beneficial, in that it encourages the development of growth opportunities to optimal levels. Once a loan to finance a growth opportunity is made, Scott argues, a debtor firm has an incentive to under-invest effort and resources and to develop the growth opportunity to less than optimal levels. The lender who takes a broad floating lien and insists on exclusive financing has enough leverage over the debtor firm to compel optimal exploitation of the opportunity. See Scott, *supra* note 20, at 920-21, 927.

317. There is some evidence that the secured lending market is competitive. See Kripke, *supra* note 133 at 971, 973-74 (noting the entry of commercial banks into the field of secured lending, which was once the preserve of the finance companies); Weiss, *Who Says Banks Are Your Only Finance Option?* Bus. Wk. 96, (Nov. 3, 1986), (noting entry of banks into asset-based lending market and decline of interest rates due to competitive pressures);

cross-collateralization provisions in purchase money inventory financing has both business justification and policy support, there seems to be no reason to regard it with suspicion.

E. "You Can Always Get a Subordination Agreement"

It has occasionally been suggested that allowing a purchase money inventory financier to cross-collateralize to any degree is simply unnecessary.³¹⁸ To use Paradigm 2 as an example once again, if Felicitous and Larry wish to include future advance and after-acquired property clauses in their agreement, the argument goes, let them do so. Under the transformation rule, Felicitous loses its status as a purchase money creditor.³¹⁹ Nevertheless, Felicitous can determine from Bucolic's filing (and perhaps further direct inquiry to Bucolic) that Bucolic has a prior perfected security interest in inventory, including after-acquired inventory. U.C.C. section 9-316 expressly authorizes subordination by agreement, and Felicitous can acquire priority over Bucolic by negotiating a subordination agreement providing for Felicitous' priority as to all inventory which Felicitous finances. If Felicitous perfects its ordinary cross-collateralized security interest properly, it will likewise enjoy priority over all subsequent secured creditors.

The first difficulty with the foregoing argument is that it ignores the possible difference in transaction costs between a legal scheme which permits limited cross-collateralization (and the simultaneous retention of purchase money status) and one which requires the cross-collateralizing party to obtain a subordination agreement from prior-filed floating lienors. If the Felicitous/Larry limited cross-collateralization agreement is enforced as written and Felicitous retains purchase money status, Felicitous is able to achieve priority over Bucolic even without the latter's consent. The cost of Felicitous' attainment of priority over Bucolic consists of the cost of a U.C.C. record search, the cost of providing (probably a form) notice to Bucolic, and the cost of filing Felicitous' own financing statement. If Felicitous may not cross-collateralize and retain purchase money status, sending a U.C.C. section 9-312(3) notice becomes pointless, and that cost is therefore saved; however, the cost of negotiating, drafting, and exe-

Diamond, *Factoring and Asset-Based Lending*, CREDIT AND FINANCIAL MANAGEMENT 19, 20-22 (Dec. 1984) (noting increased bank participation in asset-based lending, competitive pressure on loan prices, and capacity in excess of demand); Macur, *Asset-Based Lending: A Performance Evaluation*, CREDIT AND FINANCIAL MANAGEMENT 11, 13 (Dec. 1984) (disagreeing with views of some analysts that asset-based lending market is saturated, but conceding a "wealth of competition"); Logan, *supra* note 315, at 16 (noting declining rates for asset-based loans due to competitive pressures and greater efficiency in loan handling); Diamond, *supra* note 316 at 43 (increased competition has reduced rate differential between secured and unsecured lending).

318. In *Southtrust*, the bank argued that the transformation rule would not seriously inconvenience purchase money financiers because the latter could retain priority over a previously perfected creditor by obtaining a subordination agreement. The court did not expressly address this argument, although it did adopt a version of the transformation rule. See *Southtrust*, 760 F.2d at 1242. A similar argument appears in B. CLARK, *supra* note 70 ¶ 3.09[2][c] at 3-99 (2d ed. 1988); see also Hansford, *supra* note 203, at 261-62.

319. Under the *Southtrust* version of the transformation rule, it may be that the mere inclusion of such clauses in the agreement is not enough to forfeit purchase money status. However, if multiple advances and inventory purchases are actually made, and if there is no payment allocation formula, purchase money priority is lost. See *Southtrust*, 760 F.2d at 1243.

cuting a subordination agreement with Bucolic is substituted for it and, in all probability, is higher.³²⁰

Indeed, the problem may be more serious than simple increased transaction costs. Felicitous may not be able to obtain a subordination agreement from Bucolic at all. One practical problem noted by Professor Lloyd is that the bank employee who must be asked to sign the subordination agreement will likely be a non-lawyer. To that employee, the subordination agreement may appear on its face to be antithetical to the bank's interest, whether or not that perception is accurate.³²¹

More fundamentally, however, Bucolic as a prior perfected floating lienor would appear to have little incentive to accede to a request for a subordination agreement. Suppose that an extreme form of the transformation rule is in effect and the use of either a future advance clause or an after-acquired property clause results in a forfeiture of purchase money status. Suppose further that Larry and Felicitous contemplate the execution of an agreement in the form described in Paradigm 2. The agreement can create, at best, an ordinary cross-collateralized security interest in a limited class of inventory, and Felicitous must, if it desires first priority, seek subordination of Bucolic's floating lien. Bucolic presumably either believes that Larry's sales will be able to support the additional load of debt, or it does not. If Bucolic does so believe, then it would appear to be in its interest to refuse the request for a subordination agreement and try to induce Larry to finance its inventory through Bucolic rather than Felicitous.³²² Felicitous must, at that point, either retire from the field, resign itself to a second priority position, or enter into an arrangement with Larry resembling Paradigm 1, with its greater monitoring and accounting costs. If, on the other hand, Bucolic does not believe Larry's business will support additional debt, there would seem to be no incentive to subordinate its own security interest to that of Felicitous and thereby enable Larry to incur debt which will hasten Larry's demise.

The foregoing argument is, to some extent, overstated. Specifically, there may be reasons (other than stupidity or neglect) why Bucolic might not wish to make further inventory advances to Larry but might have no objection to another creditor doing so. Bucolic might, for example, be poorly equipped to monitor inventory as a form of collateral, or it may wish, for the purpose of diversifying its loan portfolio, to channel its funds to different debtors and/or different kinds of businesses. Nevertheless, the argument may hold true in some range of cases, and, if it does, the possibility of a subordination agreement is not an acceptable substitute for a legal regime which permits cross-collateralization with a retention of purchase money status.

320. Of course, if there are multiple prior secured creditors, the problem is only compounded.

321. See Lloyd, *supra* note 8, at 5-6 n.22. See also Marshall, *Commercial Law, (Annual Survey of Ga. Law)*, 37 MERCER L. REV. 139, 154 (1985) ("Anyone familiar with the likelihood of voluntary subordination in the world of commercial financing should know that even mentioning such an argument gives it more credence than it deserved.").

322. Indeed, on the Jackson-Kronman theory, Bucolic is at a competitive advantage in bidding for the additional financing opportunity. See *supra* notes 158-60 and accompanying text.

F. *The Drafting History of U.C.C. Section 9-107*

Professor Hansford, who approves of the result in *Southtrust* but faults the court's reasoning,³²³ purports to find a basis for its restrictions on purchase money financing in his conclusion that the drafters of the U.C.C. intended the purchase money provisions to be read narrowly.³²⁴ In Hansford's view, the intention to confine the purchase money priority within narrow bounds is supported in part³²⁵ by the rather sketchy drafting history of U.C.C. section 9-107. The 1952 Official Draft of U.C.C. section 9-107 contained a subsection (c), which included within the category of "purchase money security interest" a security interest:

taken by a person who for the purpose of enabling the debtor to pay for or acquire rights in or the use of collateral makes advances or incurs an obligation not more than ten days before or after the debtor receives possession of the collateral even though the value given is not in fact used to pay the price.³²⁶

The additional subsection was characterized as a presumption designed to eliminate difficulties of tracing advances made for the purpose of enabling the debtor to acquire collateral.³²⁷ It was eliminated from subsequent drafts with the rather cryptic statement that it "extends the purchase money concept too far" and "creates very difficult problems in the determination of priorities between conflicting security interests since it makes priorities in affected cases depend upon the accident of whose money, as between competing secured parties, was actually used."³²⁸

The statement that abandoned subsection (c) took "the purchase money concept too far" and is so vague as to be useless as a guide to construing current U.C.C. section 9-107. The expression of concern over priorities among "conflicting security interests" is ambiguous in that it is not clear whether the perceived

323. Hansford, *supra* note 203, at 261, 262.

324. *Id.* at 259, 262.

325. The other support Hansford identifies for the thesis that the purchase money provisions of Article 9 are to be read narrowly include the notice and perfection requirements apparent on the face of § 9-312(3) and its unusual restrictions on the extent to which proceeds in the form of accounts may be claimed as collateral. See Hansford, *supra* note 203, at 259. As argued above, the special restrictions on the purchase money inventory financier's claim to proceeds actually support (on grounds of fairness) an *expansive* reading of § 9-107(b) to permit limited cross-collateralization. See *supra* notes 267-78 and accompanying text. The notice requirement is intended to protect a prior lender from making fresh nonpurchase money advances against new inventory acquired with the funds of a purchase money creditor and entails nothing about how broadly the purchase money provisions should be read. See Hansford, *supra* note 203, at 259; Official Comment 3 to U.C.C. § 9-312. The perfection requirement presumably fulfills the usual function of notice to subsequent creditors. It is difficult to find support in any of this for a "narrow" reading of the Code's purchase money provision. For a thorough exposition of the drafting history of the Code's purchase money provisions and an argument that the drafting history actually supports limited cross-collateralization in the context of inventory financing, see Beard, *supra* note 203 at 466-79.

326. U.C.C. § 9-107(c), 1952 Official Draft, quoted in Lloyd, *supra* note 8, at 40. For a concise summary of the drafting history of § 9-107, see Lloyd, *supra* note 8 at 40-43. The complete text of the 1952 Official Draft of § 9-107 is reprinted in 15 KELLY ed., *UNIFORM COMMERCIAL CODE DRAFTS* 202 (1984).

327. See 2 J. WHITE & R. SUMMERS, *supra* note 62, § 26-5 at 507 (quoting Official Comment 1 to the 1952 Official Draft). The text and Official Comment to the 1952 Official Draft of § 9-107 are reprinted in 15 KELLY ed., *supra* note 326 at 202-03.

328. 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE § 9-107 at 262, quoted in 2 J. WHITE & R. SUMMERS, *supra* note 62, § 26-5, at 507. The complete text of the 1956 recommendations is reprinted in 18 KELLY ed., *supra* note 326 at 1-339.

problem is determining priorities between conflicting purchase money security interests or between a purchase money security interest and some other form of security interest. The recollection of Professor Kripke is that the problem with subsection (c) was that it generated competing purchase money security interests, necessitating a set of priority rules within the general purchase money priority.³²⁹ While Professor Kripke does not elaborate, it is fairly easy to surmise what he had in mind. Under abandoned subsection (c), if one secured creditor made a 10,000 dollar advance to a debtor five days prior to the delivery of 10,000 dollars worth of goods to a debtor, and a second secured creditor made a 10,000 dollar advance to the same debtor five days after delivery, both would hold purchase money security interests in the goods. Some method would have to be found for resolving a priority conflict between them, and one possibility would be to ascertain (if possible) which creditor's funds were actually used to pay for the goods. Since the subsection was designed to avoid such tracing problems, little seems to be gained by it.

If there is any lesson to be learned from the abandonment of subsection (c), however, it would seem to be merely that a purchase money creditor must be prepared to demonstrate that his advance (or other value) was actually used to enable the debtor to acquire the collateral and not merely that it was made for that purpose. As noted earlier, a check payable directly to the debtor's supplier, or to the debtor and the supplier jointly, seems the logical approach.³³⁰

Nothing that has been said so far, however, demonstrates any incompatibility between current U.C.C. section 9-107 (or the reading the drafters "intended") and the limited cross-collateralization arrangements found in Paradigm 2 or Variant A of Paradigm 3. Granted, the purchase money creditor's advance must, in purpose and in fact, enable the acquisition of the collateral. Limited cross-collateralization simply does not abandon the "enabling" requirement. All debt under such an arrangement is enabling debt, and all collateral is purchased with the purchase money creditor's funds. All that is eliminated is any requirement that a series of purchase money advances be treated as separate debts (as in Paradigm 1) or as separate segments of a consolidated debt, or that the items in the corresponding series of collateral purchases be correlated individually with the separate debts or debt segments. Nothing in the sad tale of abandoned subsection (c) precludes such an arrangement.

G. *"Too Much Collateral"*

In the foregoing subsections, the principal arguments used by courts and commentators for denying purchase money status to any arrangement which includes cross-collateralization (or accomplishes the same result through refinancing) have been surveyed and found wanting. Indeed, on grounds of policy, fairness, and theoretical and financial economy, limited cross-collateralization arrangements should be permitted. There remains in the judicial opinions, and to a lesser extent in some commentary, one additional factor to be addressed.

329. See Kripke, *supra* note 133, at 956.

330. See *supra* note 91.

That factor is less an argument than a vague judicial feeling of uneasiness over the fact that cross-collateralization (or consolidation of purchase money debt on refinancing) makes it possible for a secured creditor to retain a security interest in all the collateral until the entire debt is repaid. The discomfort has been expressed by a perjorative reference to a security interest which "lingers" longer than a security interest under a FIFO payment allocation provision.³³¹ In the context of financing of household goods, the recitation of this aspect of cross-collateralization has been part of the factual basis for a finding of unconscionability.³³² The judicial uneasiness has seldom been as clearly expressed as in *In re Brouse*,³³³ an opinion by the same Bankruptcy Referee who decided *In re Simpson*.³³⁴

In *Brouse*, the debtor in bankruptcy had made a series of credit purchases under a series of retail installment contracts with a local Gamble-Skogmo store.³³⁵ The purchases were spread in time between September 1965 and November 1967 and included items of relatively little value (clothing, an aquarium, ice cube trays, etc.) as well as slightly larger purchases like the stereo (purchased in 1965) and cupboard (purchased in 1967) at issue in the case.³³⁶ The retail installment contracts included an add-on provision which effectively

331. See *Pristas*, 742 F.2d at 800. The court in *Pristas*, however, did not invalidate the cross-collateralization provision at issue. Rather, it adopted the "dual status" rule and found the requisite payment allocation method in a Pennsylvania statute requiring pro rata apportionment of payments according to original cash sale price. *Id.* at 801-02.

332. See, e.g., *Williams v. Walker Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965); *Butterworth Furniture Co. v. Penny (In re Penny)*, 15 Bankr. 124 (Bankr. E.D. Va. 1981) (series of six separate purchase money security agreements, each of which consolidated previous balances and preserved security interest in all collateral until consolidated balance paid in full held void for violation of Virginia payment allocation statute; court cites unconscionability cases as additional support); *Coronado v. Beach Furniture and Appliance, Inc. (In re Coronado)*, 7 Bankr. 53 (Bankr. D. Ariz. 1980) (where no collateral could be released under consolidated purchase money debts until entire consolidated balance paid, purported security interest was void on grounds of unconscionability); *Associates Fin. v. Conn (In re Conn)*, 16 Bankr. 454, 459 (Bankr. W.D. Ky. 1982) (court applying dual status rule selects FIFO payment allocation principle in part because it permits security interest in some items of collateral to terminate before repayment of entire refinanced debt); *In re Jackson*, 9 U.C.C. Rep. Serv. 1152 (Bankr. W.D. Mo. 1971) (charge account with cross-collateralization provisions held unconscionable). Other courts have suggested, without actually holding, that payment allocations which either preserve a security interest in all collateral until a consolidated debt is fully paid, or that allocate payments pro rata to different items of collateral, would be unconscionable. See, e.g., *Bond's Jewelers, Inc. v. Linklater (In re Linklater)*, 48 Bankr. 916, 919 (Bankr. D. Nev. 1985) (court applies dual status rule but notes policy behind transformation rule of preventing "over-reaching" creditors from retaining title to all items of collateral until last item is paid for); *Greenville Inc. v. McCall (In re McCall)*, 62 Bankr. 57, 58-60 (Bankr. M.D. Ala. 1985) (dictum that security interest which remains in all items of collateral until combined debt is paid is "overreaching" and an "abuse"); *Matter of Beasley*, 23 Bankr. 404, 406 (Bankr. E.D.N.C. 1982) (where creditor consolidated three successive purchase money loans and attempted to make all collateral secure the entire consolidated debt, instead of incorporating the state statute providing for pro rata payment allocation according to the ratio of original cash sale price, creditor was "attempting to get more security than it was entitled to."); *In re Gibson*, 16 Bankr. 257, 268-69 (Bankr. D. Kan. 1981) (court applying dual status rule adopts FIFO payment principle, noting that pro rata allocation methods have been attacked as unconscionable); *Mulcahy v. Indianapolis Morris Plan Corp. (In re Mulcahy)*, 3 Bankr. 454, 458 (Bankr. S.D. Ind. 1980) (FIFO payment allocation principle mitigates possibly unconscionable effect of cross-collateralization provisions using pro rata payment allocation); *Russell v. Associates Fin. Servs. of Okla., Inc. (In re Russell)*, 29 Bankr. 270, 274 (Bankr. W.D. Okla. 1983) (FIFO allocation principle defended on ground it thwarts unconscionability challenges).

333. 6 U.C.C. Rep. Serv. 471 (Bankr. W.D. Mich. 1969).

334. 4 U.C.C. Rep. Serv. 243 (Bankr. W.D. Mich. 1966).

335. 6 U.C.C. Rep. Serv. at 471.

336. *Id.* at 472.

consolidated all previous balances and carrying charges with the debt created by each new purchase and made all the goods collateral for the consolidated debt.³³⁷ The secured creditor had not filed a financing statement, but claimed a purchase money security interest in consumer goods, which is perfected without filing.³³⁸

The Referee denied purchase money status to the creditor's security interest in the stereo, relying primarily on variants of the argument that a purchase money security interest may not secure more than "its price" and the argument based on the "antecedent debt" language of Official Comment 2 to U.C.C. section 9-107.³³⁹ He also relied on a pre-Code opinion of his own, in which he had denied conditional sales contract status to a similar add-on arrangement, noting in passing that "it is not only possible but frequently likely that the previously sold items may have only nominal or no value at the time of the sale, or, *because of previous payments, the security may be disproportionate to the debt.*"³⁴⁰

It is worth considering what this vaguely articulated feeling that cross-collateralization makes collateral "disproportionate to debt" could mean. Perhaps it is a reference to the fact that a purchase money inventory financier who is allowed even limited cross-collateralization has the potential to become "over-secured," *i.e.*, to have collateral the value of which exceeds the purchase money debt.

The mere possibility of a collateral cushion, however, is not an adequate explanation of the apparent judicial discomfort with cross-collateralization. In the first place, the possibility of a collateral cushion is in no sense unique to cross-collateralization arrangements. It is a possibility with any kind of security interest, and it will occur whenever payments are made before collateral is disposed of or depreciates in value. Thus, if Felicitous finances Larry's acquisition of 60,000 dollars worth of widgets on January 1, Larry sells no widgets prior to making a 20,000 dollar payment on February 1, and widgets do not deteriorate in value, Felicitous has a collateral cushion on February 1 even if Larry and Felicitous never deal with each other again. Nor does it matter if, instead of purchase money financing, Felicitous simply makes advances against inventory after delivery to Larry. If payments precede disposition or depreciation, there is a collateral cushion.

Of course, a cross-collateralization agreement may make it easier to maintain a collateral cushion because it prevents a release of the security interest in any inventory remaining on hand until the entire debt is paid. It is difficult without more, however, to identify anything wrong with that in the context of inventory financing. As Gilmore observed many years ago, "when a \$1,000 loan is secured by \$100,000 worth of assets, the secured creditor gets \$1,000, not

337. *Id.*

338. *Id.* at 472-73.

339. *Id.* at 474. Oddly enough, the court also held that the PMSI in the cupboard survived, largely because, in the period of time between the purchase of the stereo and the purchase of the cupboard, Michigan had enacted a statute permitting consolidation of debt and providing for a pro rata payment allocation method. *Id.* at 474-75.

340. *Id.* at 473 (emphasis added).

\$100,000.”³⁴¹ If, upon default, foreclosure, and sale of the collateral, the secured party realizes a surplus over the amount of the debt, the Code requires him, in most cases, to account to the debtor (or junior secured creditors) for that surplus.³⁴² Neither cross-collateralization nor the possibility of a collateral cushion raises any eyebrows when an ordinary security interest is at stake and there is no principled reason why they should be regarded with suspicion when a purchase money secured party is involved. Indeed, the purchase money inventory financier in particular has more reason to maintain a collateral cushion than most secured creditors. In the case of inventory held for sale, his collateral is among the most volatile. If the debtor is doing his job, the collateral is disposed of quickly, and the secured party may neither follow (and claim) the goods in the hands of a buyer in the ordinary course of business nor claim as proceeds the accounts or chattel paper generated by the disposition.³⁴³ Given the special disabilities under which the purchase money inventory financier must operate, it seems only prudent for him to use some device like limited cross-collateralization in order to maintain a collateral cushion.

It therefore appears that maintaining collateral with a value in excess of debt in no way violates Code provisions or policy, and the concern over the “disproportionate collateral” purportedly generated by cross-collateralization must be explained in some other way. It might be suggested that the explanation lies in a concern for the claims of the debtor’s unsecured creditors, who are too often left holding worthless claims against an insolvent debtor while secured creditors gobble up all the debtor’s assets.³⁴⁴

That suggested explanation, however, is no better than the first. Even adopting the strictest form of the transformation rule and making creditors

341. Gilmore, *The Purchase Money Priority*, 76 HARV. L. REV. 1333, 1336 (1963). Gilmore’s observation apparently escaped the attention of the court in *In re Ionosphere Clubs, Inc.*, 112 Bankr. 78 (Bankr. S.D.N.Y. 1990). In that case, a group of foreign banks (collectively referred to as the “Airbus Lenders”) had financed the acquisition of a portion of Eastern Airlines’ fleet of aircraft. The purchase money advances were secured by a Trust Indenture creating a “Floating Collateral Pool” consisting of the aircraft purchased with Airbus Lenders’ advances as well as other aircraft. The Floating Collateral Pool secured not only the Airbus Lenders’ loans, but advances from other lenders as well.

The court was extremely troubled by the disparity between the outstanding balance of the Airbus Lenders’ loans (\$95.8 million) and the fair market value of the Floating Collateral Pool (\$820 million). This concern would have been understandable and proper had Airbus Lenders attempted to repossess collateral in the Floating Collateral Pool other than the aircraft purchased with Airbus Lenders’ advances. See *supra* note 304 and accompanying text. However, the Airbus Lenders sought relief only with respect to aircraft remaining in the pool which had been purchased with Airbus Lenders’ own advances. It is therefore not apparent that Airbus Lenders was oversecured at all, even if (contrary to the thesis of this section) there was some reason to regard a collateral cushion with suspicion. However, from a false assumption that the secured creditor was oversecured, the court drew the fallacious conclusion that collateral worth more than a remaining balance secured more than “its price.” *Id.* at 86. The court ultimately denied purchase money status to the Airbus Lenders’ security interest. For criticism of the “its price” argument, see *supra* notes 250-54 and accompanying text. For criticism of other aspects of the *Ionosphere* opinion, see *supra* note 304 and accompanying text.

342. U.C.C. § 9-504(1) and (2).

343. See *supra* notes 270-75 and accompanying text.

344. See, e.g., Countryman, *Code Security Interests in Bankruptcy*, 75 COM. L.J. 269 (1970); Kripke, *supra* note 133, at 959. But see Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986). Buckley points out that unsecured trade credit is not particularly cheap (in terms of cash discounts foregone) and questions the assumption that unsecured creditors have some kind of inherent right, for which they have not paid (presumably in the form of price concessions), to a share of the bankrupt’s estate.

elect between purchase money status and cross-collateralization in any form will not help unsecured creditors. All the transformation rule does is convert a purchase money secured creditor into an ordinary secured creditor.³⁴⁵ As long as the creditor is perfected, however, he still enjoys priority over unsecured creditors; he simply becomes vulnerable to a nonpurchase money floating lienor who has filed or perfected earlier. As long as the Code permits ordinary secured creditors to cross-collateralize at will and create the broad floating lien (a matter as to which the Code is unequivocal),³⁴⁶ the transformation rule can do little to eliminate the prospect of a secured creditor feast and a simultaneous unsecured creditor famine.³⁴⁷ A concern for the unsecured creditor therefore neither explains nor justifies denying the purchase money creditor (and no one else) the benefits of even limited cross-collateralization or regarding his collateral as "disproportionate."

At this point, however, it takes some creativity to imagine what sense can be made of the notion that a cross-collateralizing purchase money inventory financier has "disproportionate collateral." If one is given to flights of fancy, one can imagine a theoretically possible, but certainly very rare, case in which a limited cross-collateralization arrangement could result in an arguably preferential transfer under section 547(b) of the Bankruptcy Code.³⁴⁸ Suppose, for example, that on January 1, Larry owes Felicitous 50,000 dollars as a result of previous purchase money advances. Suppose further that the widgets in Larry's inventory are worth only 10,000 dollars. Felicitous is obviously undersecured by 40,000 dollars. Suppose that on February 1, Felicitous makes a 10,000 dollar advance to enable Larry to purchase 10,000 new improved widgets. Larry files a petition under Chapter 7 of the Bankruptcy Code on February 15, so that the February 1 advance and the attachment of Felicitous' interest in the new improved widgets occurs within the ninety-day preference period of 11 U.S.C. section 547(b)(4). Suppose further that, due to a rapid increase in popularity and a short supply,³⁴⁹ new improved widgets appreciate rapidly in value and, upon sale by the bankruptcy trustee, the 10,000 new improved widgets bring 30,000 dollars. It is arguable that, if Felicitous is allocated the entire 30,000 dollars, it

345. See *Southtrust*, 760 F.2d. at 1243. The exception, of course, is in the case of a purported PMSI in consumer goods when the secured creditor fails to file, relying on the automatic perfection provisions of U.C.C. § 9-302(1)(d).

346. See *supra* notes 68-90 and accompanying text.

347. Indeed, it seems doubtful that such a prospect can be eliminated completely as long as a system of secured credit is allowed at all. See also Kripke, *supra* note 133, at 975-79 (suggesting that even the abolition of secured credit would lead to use of alternative devices to accomplish the same result); White, *supra* note 133, at 481-89 (suggesting that, even in the absence of secured credit, unsecured creditors will receive little or nothing in bankruptcy).

348. 11 U.S.C. § 547.

349. Some such assumption of market disturbance is necessary or the value of the new improved widgets upon sale by the trustee (or by Felicitous after repossession) cannot be greater than their original cost. Normally, the buyer at such a sale must be someone (like Larry) capable of dealing in goods of that kind and, therefore, capable of buying them from the manufacturer. Absent scarcity, increased production cost, or some other factor making the price of widgets from the manufacturer rise rapidly, there is no reason for such a buyer to buy from the trustee or Felicitous at a price greater than that charged by the manufacturer. Cf. Goldman, *How to Avoid Problems in Floorplan Financing*, 31 PRACTICAL LAWYER No. 4, 51, 54 (1985) (noting that a typical repurchase agreement between a purchase money inventory financier and the debtor's supplier provides for the repurchase of repossessed inventory at the lesser of original cost or outstanding balance).

has received a preferential transfer in the amount of 20,000 dollars,³⁵⁰ the extent to which its previously undersecured debt has been "resecured."³⁵¹

The statement of the problem, of course, demonstrates its insignificance. The normal course of business inventory collateral is to depreciate or disappear into the hands of buyers, not to appreciate.³⁵² Moreover, even if such a case did arise, there is no reason to suppose the existing mechanism for setting aside

350. The argument is possible because, under § 547(c)(3), a "transfer" within the meaning of § 547(b) does not occur until the debtor has rights in the "property transferred"; in this case, the newly-acquired collateral. Thus, the attachment of a security interest (purchase money or ordinary) in the debtor's newly-acquired property under an after-acquired property clause counts as a "transfer" under § 547(b). See 2 J. WHITE & R. SUMMERS, *supra* note 62, § 25-6 at 437. Of course, in the usual case, the value of the collateral will never be higher than at the time of its purchase, and, under a limited cross-collateralization arrangement, the secured party's contemporaneous enabling advance will insulate the attachment of his security interest from attack as a preference, either on the grounds that it is not taken for "antecedent debt" under § 547(b)(2), that it does not improve his position under § 547(b)(5), or that it does not change the debt/collateral ratio to the detriment of unsecured creditors under § 547(c)(5). See *id.* § 25-4 at 425, 426, 427-28, § 25-6 at 438. Indeed, the present writer is in agreement with the positions of Professors White, Summers, and Clark that even if collateral does appreciate subsequent to acquisition and within the 90-day preference period, such appreciation is not a "transfer" and so no preference has occurred. See *id.* § 25-6 at 438-39, and authorities cited therein. See also B. CLARK, *supra* note 70, ¶ 6.03[5][b][i] at 6-51 to 6-52. Even if that position is not accepted, however, the trustee's avoidance powers seem quite adequate to cope with such bizarre preference problems.

351. Obviously, absent the intervening bankruptcy, there is no policy reason to object to allocating the entire \$30,000 to Felicitous. Its advance, after all, made possible the acquisition of the new improved widgets, and its entire remaining debt was, at its inception, purchase money debt. Felicitous has thus neither sought to promote nonpurchase money debt to purchase money status nor appropriated nonpurchase money collateral to its debt, and such appropriation is the vice to be avoided in cross-collateralization arrangements. See *supra* notes 170-72 and accompanying text. It is, of course, arguable on the basis of the "its price" language of § 9-107(a) or the "in fact so used" language of § 9-107(b), that there is a *textual* reason to require, in the unlikely event that a disposition of collateral produces more than its original cost, the excess value accrued to junior secured creditors or the debtor rather than the purchase money financier. Such a view was adopted, with little discussion, by the Bankruptcy Court in *In re Sunrise R.V. Inc.*, 107 Bankr. 277 (Bankr. E.D. Cal. 1989). If so, such a requirement will probably be invoked so rarely as to be insignificant, as collateral appreciation is hardly an everyday occurrence. In the case of fungible collateral like widgets, the usual post-default liquidation sale may not even apportion the price among the numerous items of collateral, and ascertainment of such appreciation may thus be impossible even in the unlikely event it occurred. It would seem that, only in cases like *Sunrise R.V.*, where a) the collateral consists of big-ticket items like recreational vehicles, and b) upon default or bankruptcy, the collateral can still be sold at retail, can the question of collateral appreciation arise. In any event, an interpretation of the language of § 9-107(a) and (b) to accommodate such rare cases is a far cry from the "one-to-one correspondence" between debt and collateral which the *Southtrust* court inferred from the same language.

352. Of course, the definition of "inventory" in U.C.C. § 9-109(4) includes not only business inventory held by a merchant for resale, but also the raw materials and work in process of a manufacturer. Accordingly, the statement in the text must be qualified, since the goal of the manufacturer is precisely to combine the raw materials into a finished product, the value of which is greater than the sum of the values of its parts. However, the bankruptcy implications of such increases in value are not serious. If there are no traceable inputs into the manufacture of the product other than raw materials financed by the purchase money secured party, the increase in value would appear to be a case of simple value accretion without a "transfer," as discussed *supra* at note 350. If some of the materials included in the final product are subject to the security interests of rival secured creditors, U.C.C. § 9-315(2) provides a simple pro rata priority scheme which appears, on its face, to be a qualification of the purchase money superpriority. See also Official Comment 4 to § 9-315. Cf. B. CLARK, *supra* note 70, ¶ 8.04[5] at 8-33. If, on the other hand, identifiable and measurable contributions to the final product are made by unsecured creditors (e.g., employees or utility companies), there is the theoretical possibility of a preference. However, once again the use of traditional mechanisms to avoid the preferential portion of the value increase presents no conceptual difficulty, although there is some disagreement as to whether the practical difficulties in valuing unsecured creditor inputs and establishing causal connections destroy the utility of attacking such preferences. Compare 2 J. WHITE & R. SUMMERS, *supra* note 62, § 25-6 at 439 (arguing that the pursuit of such attenuated arguments is not an intelligent expenditure of judicial time and that "[t]he wheels of bankruptcy do not grind so fine") with B. CLARK, *supra* note 70, ¶ 6.03[5][b] at 6-52 and 6-53 (arguing in favor of treating such value additions as preferences).

preferential transfers could not be used to deal with it as effectively as is common with ordinary security interests with after-acquired property features.³⁵³ There is nothing peculiar about purchase money inventory financing which warrants wholesale prohibition of limited cross-collateralization out of a concern for preferential transfers, especially when the preference problems arising from ordinary cross-collateralized security interests can be handled without such a blanket prohibition.

At bottom, then, the expressions of concern over "lingering" security interests or "disproportionate collateral" seem little more than emotional invective. They are probably understandable enough in the context in which they arose, *i.e.*, the operation of an "add on" clause in a transaction involving a consumer's purchases of household goods. The fact that, in cases like *Brouse*, a consumer's socks are still encumbered two years after purchase³⁵⁴ seems distasteful because of the almost universal assumption that it is a good thing for people to own their household goods free and clear. Depending on one's politics, that assumption may seem self-evident, benign or simply bourgeois.

More importantly, such an assumption would not appear to translate automatically to the inventory of a business. The Code permits the dealer in goods to transfer his inventory to buyers in the ordinary course of business free of even a purchase money security interest in favor of his lender.³⁵⁵ The Code likewise does nothing to impede the debtor's ability to grant a rival lender a superior interest in the accounts or chattel paper resulting from sales of purchase money collateral.³⁵⁶ The Code also permits the dealer in goods to seek new sources of credit for inventory purchases by giving him the power to grant new purchase money priority to each successive purchase money financier. Limited cross-collateralization by a purchase money inventory financier does not diminish any of these powers of the debtor, and, since there is no interference with new sources of credit or inventory sales, there would seem to be no reason to be concerned with whether the dealer owns the goods "free and clear." Indeed, in the case of Paradigm 2 and Variant A of Paradigm 3, prohibiting cross-collateralization in favor of a purchase money inventory financier would not "free" the debtor's inventory of all liens; it would simply award priority to the floating lien of Bucolic Bank.

IV. CONCLUSION

The discussion of Part III has demonstrated that none of the stock arguments against limited cross-collateralization by a purchase money inventory financier are meritorious. Limited cross-collateralization arrangements are both conceptually and practically simpler than alternative forms of purchase money inventory financing, and are susceptible of business justification. Limited cross-collateralization contravenes neither the Code nor its Official Comments, and it

353. The avoidance powers conferred by the initial two clauses of § 547(b) are hardly mysterious or unfamiliar.

354. See *In re Brouse*, 6 U.C.C. Rep. Serv. 471 (Bankr. W.D. Mich. 1969).

355. See U.C.C. § 9-307(1).

356. See U.C.C. §§ 9-312(3), 9-308(b).

is compatible with the most plausible justifications for purchase money priority. Given the Code's stated purpose to "simplify, clarify, and modernize"³⁵⁷ commercial transactions, and especially its stated purpose to "permit the continued expansion of commercial practices,"³⁵⁸ limited cross-collateralization arrangements should be permitted through the vehicle of further judicial construction of the Code.³⁵⁹

357. U.C.C. § 1-102(2)(a).

358. U.C.C. § 1-102(2)(b).

359. While the present writer's view is that legislation is not necessary in order to permit limited cross-collateralization, two states, Tennessee and Louisiana, have attempted to nullify the *Southtrust* rule by nonstandard amendments to U.C.C. § 9-107. Tennessee has added a subsection (c), which provides that a security interest is a purchase money security interest to the extent that it is:

(c) under subsections (a) and (b), a purchase money security interest upon any unpaid balance in preexisting collateral arising pursuant to a series of purchases or extension of payment time and terms. Provided, however, that whenever the collateral is consumer goods, the creditor retains no purchase money security interest in any property as to which he has received payments aggregating the amount of the sale price including any finance charges attributable thereto. For the purposes of this section, in the case of items purchased on different dates, the first item purchased shall be deemed the first paid for, and in the case of items purchased on the same date, the lowest priced item shall be deemed first paid for. TENN. CODE ANN. § 47-9-107 (1990).

The recently-enacted Louisiana version of §9-107 contains a sentence following subsection (b), which reads as follows: "The fact that the collateral additionally secures other or future indebtedness of the debtor as a result of cross-collateralization shall not affect purchaser [sic] money security interest status." LA. REV. STAT. ANN. § 10:9-107 (West 1990).